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THE JOURNAL OF Taxation

A NATIONAL JOURNAL OF CURRENT NEWS & COMMENT FOR PROFESSIONAL TAX MEN

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by George J. Brady

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TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

Many tax advantages found in joint venture of corporate partners; how it works

by GEORGE J. BRADY

The unincorporated commercial joint venture in which established corporations associate themselves has, until recently, been used only in a few industries. However, specific recognition of the joint venture as a partnership under the 1954 Code has given considerable standing and impetus to wider use of the joint venture. This article explains the tax savings possible for corporate joint-venturers, how to set them up, exceptions to the general rules, especially in the case of foreign operations, and comments on liquidation of ventures when they have served their purpose or tax advantages warrant it.

THE JOINT VENTURE approach is a relatively neglected modus operandi for joint commercial activity today. Although this type of business organization has its roots in ancient Babylon, its modern counterpart is seldom used as a form of commercial combination aside from the construction and oil-and-gas industries. However, the 1954 Code emphasized its claim to the tax attributes of the partnership form by including it in the statutory definition of the term "partnership."[1] As a result of this inclusion, the joint venture can be used to effect maximum after-tax earnings during the formative years of commercial activity when sales are low, marketing and development expenses high and operating losses the rule rather than the exception.

Tax defects of corporation

The income tax consequences inherent in the use of the corporate vehicle can be likened to a two-edged sword. The first edge is the postponement and potential loss of starting-up expenses as deductions from taxable income; the second, the additional tax burden levied on intercorporate dividends. This second edge cuts down not only the transfer of earnings, but depletion reserves created through percentage depletion and profits taxed at preferential rates such as capital gains on timber profits. However, the use of the joint venture as the operating vehicle will in many instances overcome these defects.

An incorporated joint enterprise

Suppose corporations A and B are contemplating the launching of a new business. They will share the expenses and profits of this new activity equally. Each has a commitment to contribute $500,000 to get the new business off the ground and sustain it until it becomes self supporting and begins to earn profits. For purposes of our example, assume that during the first four years of operation the new business sustains losses of $200,000, $300,000, $250,000 and $100,000 respectively; in the fifth year it reaches the break-even point in operation, turning in a nominal profit of $20,000; in the sixth, seventh and eighth years, operations result in profits of $150,000, $450,000 and $500,000 respectively. For purposes of simplification, assume further that all expenses are properly deductible for Federal income tax purposes and that all income is taxable.

Initially, let us assume that our participants A and B chose to incorporate the new business under the designation of corporation C. Although it is acknowledged that, in underwriting the new corporation, they would be able to advance the funds partially in exchange for stock and partially as interest-bearing indebtedness (subject to caution against thin capitalization), let us assume in the interest of simplicity, that the entire one million dollars required was evidenced by stock.

Because of the five-year limitation on operating loss carryforwards, $30,000 of C's first year net operating loss can never be availed of. Furthermore, C will not have income available for the payment of dividends until the eighth year, at which time it will have an income before tax of $300,000. The Federal income tax on this will amount to $150,500. The accumulated earnings at this point available for dividends will be $119,500. Assuming this was paid up to the co-venturers A and B as a dividend, they would take it subject to a Federal income tax computed at an effective rate of 7.8% (52% of 15%) or $9,300, leaving a net of $110,200.

Now let us assume that in our hypothetical fact situation our co-venturers A and B, instead of launching a new business in the corporate form, had chosen the joint venture as their modus operandi, designating it A-B. Since the joint venture is for tax purposes treated as a partnership, corporations A and B will include their distributive shares of A-B's net operating income or net operating loss in the determination of their taxable income. Assuming they both have sufficient income so that any income or loss distributed by A-B will have a 52% Federal tax effect, their combined Federal income tax over the first four years of A-B's operation will be reduced by $442,000 (52% of $850,000). Over the next four years their combined Federal income tax will be increased by $582,400 (52% of $1,120,000).

This represents an increase in taxes to corporations A and B during the first eight years of operation of $140,400. Assuming that all operating income in excess of losses was paid up to the participants (as was done through the dividend in the eighth year of the corporate example), A and B will have realized $129,600 ($270,000 less taxes of $140,400).

Contrast this with the $110,200 net cash realized from use of the corporate approach — a difference of $19,400 in favor of the joint venture at the end of eight years. More importantly, the net investment required to meet losses is re-

duced as indicated in the following table:

Year	*Corporate*	*Joint Venture*
1	$200,000	$ 96,000
2	500,000	240,000
3	750,000	360,000
4	850,000	408,000
5	830,000	398,000
6	680,000	326,400
7	230,000	110,400

The difference in favor of the joint venture becomes even more significant when the new business does not meet with success. This can be readily appreciated when you refer to the tax saving of A and B under the joint venture arrangement at the end of the fourth year.

At that point A and B have realized a combined cash saving in income tax of $442,000 as contrasted with the corporate approach. Furthermore, if a joint venture in the corporate form proves unsuccessful, the loss of investment will, except in rare instances, be a capital loss to the joint venturers. In the instant case, the greatest reduction in tax that could result from the loss of $850,000 would be $212,500. However, since this loss would be a capital loss, it would be deductible to the stockholder corporation only to the extent that that corporation had capital gains within a period of six successive taxable years commencing with the year of loss.[2] Contrast this risk of loss ($637,500 to $850,000) with the risk as in the joint venture of $408,000.

Where the new business is successful from the outset, the joint venture will result in a tax saving of 7.8% (the effective tax rate on dividends received by a corporate stockholder) when the net income is paid over. When the income is retained in the corporation without being paid out in the form of dividends, the best that can be expected will be that the annual tax attendant to the corporate form will be $5,500,[3] less than that attendant to the joint venture.

Initial costs may be lost

Another advantage in the joint venture is deductibility of initial costs. Many commercial joint undertakings will incur starting-up expenses in their early years which, while they will be deductible for Federal income tax, may never provide any tax benefit because these costs may not be recovered until the taxpayer's loss carryover has been exhausted. The cost of financing in these cases is effectively doubled when the corporate form is chosen for the new operation because there is no method of offsetting the losses against current income.

Elections

For purposes of making all permanent elections,[4] the joint venture, since it has been included in the definition of partnership by statute, is generally treated as a separate "taxpayer." Thus the joint venturer enjoys a broad degree of flexibility in this vital area of taxation which would not otherwise be available to it. This flexibility enables it to overcome the deleterious effect of elections which, although at the time made they seemed to be the wisest choice, now operate to its detriment. The benefits inherent in this power can be best illustrated through an example.

Corporation X has neglected to make a proper election to deduct research and experimental expenditures as provided by Regulations under Section 174 of the Code and the corporation has been unsuccessful in its attempts to obtain permission from the Commissioner to change this election. This failure to make a proper election can be overcome by forming a partnership with affiliate corporation Y to conduct all research activities. The partnership (joint venture) X-Y can then make a proper election to deduct research and experimental expenditures currently.

Avoiding tax "as a corporation"

The joint venture, unless its founders are cautious, may find itself in a position where it is stripped of the veil of Subchapter K and exposed to the corporate tax. In order to prevent this, the founders should consider the tests which have been developed through the court decisions to determine whether the joint venture is in effect an association taxable as a corporation. These tests include:[5]

1. Continuity of enterprise, notwithstanding death or insolvency of a partner;
2. Transferability of interest as personal property;
3. Joint property profit (as against joint development for account of respective owners);
4. Holding of title to property in name of trustee or other representative;
5. Centralized management and control;
6. Limited liability.

However, unless most of these conditions are present, the joint venture should not be determined to be an association taxable as a corporation. Therefore, if the venture may be terminated at the will of or upon the insolvency or receivership of any of the venturers, a centralized corporate manager of the joint-venture enterprise may be used without incurring a separate corporation income tax on the profits of the venture. However, where significant amounts are involved, and the income tax consequences attendant to a separate taxable entity are material, advance rulings should be requested from the Treasury Department.

Subchapter K election

Of course, if the joint venture is engaged in investment activities, or in the joint production, extraction or use of property, and if the members of the partnership (joint venture) are able to compute their income without the necessity of computing partnership taxable income, the partners (joint venturers) may make an election to be excluded from the provisions of Subchapter K. When this election is made, the joint venturers renounce the power to make elections as a partnership unless permission has been received from the Commissioner to be excluded only from specified sections of Subchapter K.[6]

After the joint venture has passed through the development stage and has reached a point where it is self sufficient, the joint venturers may for one reason or another decide they want to incorporate the enterprise. At this juncture, most of the detrimental tax consequences will have been avoided and the corporate vehicle will no longer appear as unattractive as it once did. If the participants decide they want to incorporate, two avenues, each with separate and distinct tax consequences, are open.

The first approach would be for the partnership to transfer its assets to the corporation in exchange for the corporation's stock and then distribute the stock to the partners in liquidation of the partnership. Under this approach, the corporation would acquire the partnership's tax basis in the assets.[7]

The second approach would be for

[*Mr. Brady is a CPA, a partner in the accounting firm of Arthur Andersen & Co., New York. This article is adapted by him from a lecture prepared for an orientation seminar of the American Management Association.*]

the partnership to distribute the assets to the partners in liquidation of the partnership. The partners would then in turn transfer the assets to the corporation in exchange for stock. Under this approach the corporation's tax basis in the assets would be equal to the partners' tax bases in the partnership.

Choice depends on facts

A comparison of these two approaches can best be illustrated by an example. Partnership A-Z has only one asset, a building, with a tax basis of $100,000. Partners A and Z have a tax basis for their investment in the partnership of $75,000 each. Use of the first approach would result in a basis of the building to the corporation of $100,000, whereas use of the second approach would give the corporation a tax basis in the building of $150,000. Since allowable depreciation will be based on the corporation's tax basis, and since the partners' basis for the corporation's stock will be the same under either approach, the chosen approach should be the one which gives the corporation the greatest depreciable basis. Therefore, each case should be determined on its own merits.

Liquidation

At the outset, the joint venturers may have launched the enterprise with a limited objective, intending to liquidate it once that objective had been achieved; or for any other reason (the reason itself is immaterial) they may decide to liquidate the venture.

If the enterprise has been operating in the form of a joint venture and if all of the venturers intend to dispose of their interest in the venture, the liquidation can be effected by either of two methods:

1. Sale of the joint venture's assets by the joint venture itself, followed by a distribution of the cash proceeds to the participants in liquidation of the joint venture. Or

2. Sale of his joint venture interest by each participant.

The fact that substantially different tax consequences may result, depending on the method chosen, can best be illustrated by an example. Assume that joint venture A-Z has only one asset, a building with a tax basis of $100,000. Venturers A and Z each have a $50,000 basis in the joint venture. The venturers decide to sell the building and liquidate the joint venture. The best price they can get is $50,000. If method 1 is chosen and the joint venture sells the building for the $50,000, each of the participants would have an ordinary loss of $25,000 fully deductible from ordinary income. If on the other hand method 2 is used, and the individual participants sell their joint-venture interest for $25,000 each, their losses will be a capital loss which for all practical intents and purposes is deductible only from capital gain. Since different conditions will ofttimes dictate a different approach, it is imperative that, in considering the liquidation of the venture, we look at the other side of the coin, namely, when the net assets of the joint venture have a current market value in excess of the participants' tax basis in the venture. In an hypothetical case, joint venture R-S has only one asset, that being an inventory in which the venture has a tax basis of $100,000 and which presently has a realizable fair market value of $110,000. If the joint venture chooses the first approach and sells the inventory, distributing the proceeds in liquidation, the gain of $10,000 will be ordinary income to the participants.

On the other hand, however, if the participants should choose the second approach and sell their interest in the joint venture, they would realize a capital gain of $5,000 each. When liquidation of the joint venture is contemplated, and when the assets of the venture have materially appreciated over the tax basis, the venturers should be wary of the collapsible partnership provisions of Section 751.

Corporate dispositions

While we are on the subject of dispositions, it would be well to pause for a moment to look at dispositions of corporate joint entities, since instances will occur when it will be impossible to avoid the corporate form as a vehicle for the joint undertaking.

On many occasions when the corporation can be disposed of at a gain, a large part of the gain can be attributed to surplus. When the stockholders are themselves corporations, the tax consequences can be alleviated by declaring available surplus out as a dividend taxable to them at an effective rate of 7.8%, rather than realizing the entire increase in value as a capital gain taxable at 25%.

It is conceded that taxation is not the paramount consideration to be weighed in choosing the commercial vehicle for the joint enterprise. Nevertheless, this does not alter the fact that it should be a first consideration. It is much simpler to incorporate a joint venture without the recognition of taxable gain than to disincorporate a corporation free of tax. All too often the only discussion of the form to be used for the enterprise takes less than five seconds and is limited to, someone saying "Let's organize a corporation . . .!"

This discussion has emphasized the tax benefits inherent in the joint venture as opposed to the corporation. However, the author has no personal axe to grind. Occasions will arise when the corporate form will be more attractive even when taxation is the only factor being considered.

When corporation is best—foreign

Such an occasion arises when the geographic area of the venture is not limited to the United States and there is a reasonable expectation that foreign operations will be profitable. In this instance the corporate form can be the more attractive of the two.

Assume operations are conducted in a country where the tax rate is 40%. For every $100 of income earned, the venture will be subject to a combined U. S. and foreign tax of $52 if operated as a partnership, but only $40 if operated as a corporation. In the case of a corporation there would be a further tax of $7.20 in the event profits are remitted to the United States as dividends. Under these facts, there is a tax saving of $12 prior to remittance and $4.80 after remittance for every $100 of income if the venture is operated as a corporation.

Furthermore, if the venture is to operate in a number of foreign countries, it may prove advantageous to set up a holding company in a tax haven country, such as Panama. In this manner, profits from operation in one country can be remitted to the holding company and reinvested in other countries without incurring U. S. income tax.

In addition, the conduct of operations through a foreign holding company enables the joint venturers to average foreign tax credits, thereby avoiding losses of tax credits in those instances where the foreign tax rate exceeds the U. S.

[1] Sec. 761(a) of I.R.C. 1954 . . . "For purposes of this subtitle the term 'partnership' includes . . . joint venture . . ."
[2] Secs. 1211(a) and 1212.
[3] Surtax exemption.
[4] Sec. 703(b).
[5] Morrissey, 296 U.S. 344.
[6] Regs. Sec. 1.761-1(a)(2).
[7] G.C.M. 11557, XII-1 C.B. 128 S.M. 3748, IV-2 C.B. 17.
[8] Sec. 922 14/52 = 26.9231%.

tax rate. For example, the venture is conducted in countries X and Y with tax rates of 10% and 80% respectively and earns a profit of $100 in each country. If the profits are remitted directly to the joint venturers, the total tax thereon would be $132. However, if the profits were remitted to the joint venturers through the foreign holding company the total tax would be only $97.70.

If qualified as WHTC

If the operation qualifies as a Western Hemisphere Trade Corporation, its income subject to the U. S. corporation income tax is reduced by virtue of such WHTC status by slightly less than 27%.[8]

As you have seen from the foregoing discussion, there are tax benefits attendant to the use of the joint venture as a vehicle for joint commercial undertakings which cannot be availed of when the corporate form is chosen. However, situations will arise when the corporate form is more attractive. Therefore, joint venturers contemplating the launching of a joint commercial activity should seek the counsel of competent advisers early in their deliberations. Then, after careful consideration of all the pros and cons of each approach, choose that vehicle which best suits their project. ☆

Holsey reversal shows redemption is possible without creating dividend

by **SHERWIN C. PELTIN and LOUIS L. MELDMAN**

The extreme importance of the niceties of tax planning in the corporate area is well displayed by the Third Circuit's reversal of Holsey. The fine line between Holsey and Zipp (where the taxpayer lost) illustrates what the appellate courts look at in determining that a constructive dividend has been received. The Third Circuit's opinion, which is analyzed here, is a good guide to the practitioner in planning redemptions. Here also is an interpretation of why Zipp failed.

THE RECENT REVERSAL of *Joseph H. Holsey* (28 TC 962) by the Third Circuit may go far toward relieving some of the considerable anxiety[1] as to whether continuing or remaining stockholders of a closely held corporation have received a constructive dividend when another stockholder terminates his interest by a complete stock redemption. But in another sense, it may also cause confusion in future occurrences of similar transactions since it reaches a result apparently contrary to *Zipp* (28 TC 314), in which the Sixth Circuit upheld the Tax Court.

In the *Holsey* case, the taxpayer owned 50% of the outstanding shares of an automobile agency corporation. The other 50% was held by another corporation of the stock of which the taxpayer's father held 76%. Taxpayer himself was an officer and director of this latter corporation. He also held an option to acquire for $80,000 the other 50% of the stock of his corporation. The option "was not assignable by him to anyone other than a corporation in which he owned not less than 50% of the voting stock." The taxpayer assigned his option to his own corporation, which promptly exercised it, thereby acquiring 50% of its own outstanding stock for $80,000. On the date of exercise, the corporation had surplus in excess of $300,000.

The Tax Court held that the remaining stockholder had received a constructive taxable dividend of $80,000. Denying the importance of the fact that no legal obligation existed which the corporation could have discharged for its stockholder, the Tax Court emphasized the "benefit" to the remaining sole stockholder due to his obviously increased proportionate ownership. A claimed business purpose for the corporate action was rejected by the Tax Court after detailed analysis.

On appeal the majority of the Third Circuit differed with the Tax Court on the type of benefit which would render a distribution to a third party essentially equivalent to a dividend to the remaining stockholder. It held that any benefit to such remaining stockholder, the taxpayer in *Holsey*, was indirect, and that only a direct benefit, i.e., discharge of his personal obligation, would be equivalent to a dividend to him. The circuit court likened the benefit to the taxpayer to that of the possessor of any property which increases in value due to external causes, and stated that no increment should be taxable until disposition of the property, citing *Eisner v. Macomber*, 252 U.S. 189 (1920). Judge McLaughlin dissented, evidently due to an unwillingness to accept the bona fides of the entire transaction.

The position of the Third Circuit appears to strengthen the "corporate veil" in small closely-held corporations. On the facts of *Holsey*, it must be obvious that the individual taxpayer in his position of great influence in the corporation was able to use that corporation to maximize his proportionate interest without expending any of his previously owned funds, and not be taxed on a constructive dividend. The majority opinion referred to the taxpayer's having only minority control, but the other directors were his father and brother, and the other stockholder a corporation largely owned by his father and of which he, himself, was an officer and director. Yet, as interrelated and interdependent as the various parties might have been, the Court scrupulously avoids mingling corporate and individual affairs.

An added guidepost erected by the Third Circuit is the reaffirmation of its position in *Ferro*, (CA-3), 242 F.2d 838, 841 (1957). It there emphasized the significance of a change in proportionate ownership in determining dividend equivalence; if the proportionate ownership has changed, no dividend results. In *Holsey*, the taxpayer's proportionate interest increased from 50% to 100%.

The approach of the Third Circuit might be summarized as follows:

1. No dividend will result to a remaining shareholder unless the payments by the corporation in redemption of stock held by another provide a direct benefit to the remaining stockholder, such as discharging a personal obligation.

2. A dividend will probably not result to a remaining stockholder due to redemption of stock held by another if the proportionate interest in the corporation held by the remaining stockholder is altered.

Among the authorities cited by the Third Circuit majority to support its position with respect to dividend equiva-

[1] See 9 JTAX 221, Oct. 1958.
[2] See also, 9 JTAX 39, July 1958.
[3] See H. L. Jones, How Stock Redemptions Produce Dividend Income, 36 Taxes 437, 444.
[4] See note, 67 Yale Law Journal 112.

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lence of a discharge of an obligation is *Zipp* (CA-6) (1958) *aff'g.* 28 TC 314. A brief review of that case will help in illustrating the problem.[2]

In *Zipp,* according to the facts found by the Tax Court, Louis Zipp owned 48 of the 50 outstanding shares of a scrap metal corporation, with each of his two sons owning one share. To facilitate Louis' retirement, to avoid future inheritance difficulties, to eliminate family bickering and to leave the sons in full control, Louis agreed to surrender two shares of his stock to the corporation and to transfer 23 shares to each of his sons in return for consideration from the corporation totaling $93,782.50. Louis also executed several additional covenants for which, the Tax Court concluded nothing was paid.

The Tax Court agreed with the Commissioner that each son realized dividend income equal to one-half of the consideration paid to Louis, their father. The Tax Court pointed out that, by means of credit extended to their controlled corporation, the sons were able to acquire or have retired without personal expenditure all other outstanding stock, and that no partial liquidation was intended. From these factors, the court concluded that the payments to Louis were for the benefit of his sons and were equivalent to a constructive dividend to them. No authority is cited directly but a "cf." citation is made to *Wall* (CA-4), 164 F.2d. 462.

On appeal, the Sixth Circuit affirmed the Tax Court per curiam. Although little positive argument is presented in the circuit court opinion, the language used in analyzing the facts and the Tax Court opinion indicates that the appellate court regarded the use of the corporation to purchase the stock as something of a subterfuge.

Faced with a difference of opinion between the two circuits that have passed on the proposition, some evaluation naturally follows. Extension of the "benefit" rule to this type of redemption theoretically requires taxable dividend treatment of *every* redemption, since the percentage ownership of those remaining stockholders necessarily increases and a "benefit" of the Tax Court *Holsey* and *Zipp* type follows. This novel approach would tax every minority stockholder, regardless of how minute, even on those redemptions which will not ultimately benefit the corporation or its continuing stockholders, such as the redemption on retirement or death of the holdings of a valuable stockholder-executive. If that retiring executive had substantial holdings, the dividend to the remaining shareholder might be comparatively enormous. If after the redemption the corporation, having been emasculated by the loss of an essential executive as well as the serious depletion of capital in the redemption, should fail, our minority stockholder w o u l d be beneficently allowed a capital loss equal to his presumably stepped-up basis.[3] It should be pointed out, however, that this almost absurd result is not sufficient to dissuade all from accepting this approach.[4]

Perhaps, on consideration of these possibilities and their evident recognition by the Third Circuit, the Revenue Service will confine dividend treatment to those situations in which a personal obligation is discharged by the redemption, and in which the dividend equivalence can be established by factors other than the "benefit" to be derived from mere increased proportionate ownership. Although there may be danger of some tax loss by following the *Holsey* reversal, the more logical solution would be to attack directly the genuineness of the transaction itself, rather than to attack collaterally the benefits derived by a remaining stockholder. ☆

Replacement in involuntary conversion not similar

RENTAL INCOME, says Rev. Rul. 56-347, must come from a tenant engaged in the same business in order for the taxpayer to qualify under the involuntary conversion section. Relying on the Fourth Circuit decision in *Lynchburg National Bank* (208 F.2d 757, *aff'g.* 20 TC 670 (1953)), the Commissioner is again defending this position in the Tax Court *(Liant Record, Inc.,* Docket No. 72955).

The involuntary-conversion Regulation (Section 1033(a)) states that "if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted . . . into property similar or related in service or use to the property so converted, no gain shall be recognized."

The taxpayer in this case, a corporation, sold in condemnation proceedings by the City of New York its 8.7% interest in an office building from which it derived rental income and bought with the proceeds a half interest in an apartment building from which it also derived rental income. The taxpayer bases its claim on the contention that, since it exchanged one rental property for another, the apartment building is similar or related in service or use to the office building—the service or use of providing income in the form of rent—and accordingly no gain is recognizable.

The Commissioner takes the position that an apartment is not similar or related in service or use to an office and that the mere fact that the taxpayer derived rent from both does not make them so related. In this he relies on the *Lynchburg National Bank* decision in which an addition to the bank containing safe-deposit vaults was held not to be similar or related in service to a building rented to a restaurant. The restaurant was destroyed by fire and the bank used the insurance money to build the safe-deposit vaults. The fact that both buildings give rise to rental income was considered immaterial.

"The test," said the circuit court, "as to whether property acquired after a compulsory or involuntary conversion is similar or related in service or use to the property converted, is a functional one; and accordingly the test is not met by a substitution of a building used for banking purposes in place of a building used as a shoe store and a restaurant. To hold otherwise would be to say that the replacement of one commercial building by another commercial building is sufficient under the statute to avoid the recognition of gain, no matter how dissimilar or unrelated their respective purposes may be, and we do not think the statute has that meaning."

Rev. Rul. 56-347, which the taxpayer in this case seeks to override, was based on this decision and states expressly that the benefits of the involuntary conversion section are unavailable when property held for rental income purposes is condemned and the proceeds are used to purchase other rental income producing real estate when the tenants occupying the replacement property are not engaged in the same business as the tenants of the property that was condemned. ☆

How to use election under new law to save taxes on small corporations, owners

TO THE TRADITIONAL three choices for the form of a business structure—corporation, partnership (perhaps limited) or proprietorship—a new possibility is added by the 1958 tax law: Subchapter S of the Code, giving certain small corporations the option not to be taxed as corporations. It presents opportunities (and, of course, problems) that tax men everywhere are studying and trying to evaluate. Unfortunately, some companies are going to have to make this election without the benefit of final Regulations. However, the Treasury has issued preliminary regulations covering the form of election and revocation and shareholder consents. These new regulations are discussed in the following article outlining the way the new subchapter works.

Making the election, like planning to be able to qualify for election, requires some assessment of the future. In general it may be said that the election is going to be worth while and will be used year after year by firms that would under the old tax rules have chosen to be partnerships; they will accept the opportunity to have the non-tax advantages of a corporation (limited liability, transferability of shares, pension plans, fringe benefits, etc.) without the disadvantage of double taxation. But an equally important use of the new election will be by corporations for unusual years, those in which substantial assets are sold or extraordinary losses are realized. Thus, when the form of a new organization is chosen, the tax advisor must consider not only whether this election is likely to prove useful currently, but also whether there is likely to be an opportunity to use it to advantage in some one future year.

Initial losses foreseen

It has become a sort of rule of thumb that, if losses are expected in the first few years of operation of a venture and if the owners, corporate or individual, have income from other sources, a partnership or sole proprietorship or joint venture is the best form because it will provide immediate tax deductions usable against the proprietors' other income. This immediate tax deduction is frequently more attractive than the possibility that initial losses can be carried over against income in later years. There is always the chance that profits won't appear soon enough to use up the losses before the carryover expires.

We can expect that, in many situations in which the advice last year was—"don't incorporate until the business becomes profitable" will now be "incorporate, but elect not to be taxed as a corporation and retain the election until substantial profits appear."

Debt v. equity

The importance of thin capitalization has been to permit interest payments, which are deductible, to owners, and to allow the use of profits to repay the debt at no tax cost to the stockholder-lender rather than having to use dividends. This will still be good advice. If initial losses are expected and the election is made, the losses can be passed through to the stockholders to the extent of their basis for stock, and then it is applied to the basis for the debt. Consequently there need be no fear that thin incorporation will jeopardize passing losses through. Of course, if losses eat up the basis of the debt, it is likely that the stockholders will not want payment of the debt (having no basis, the repayment would be taxable). If this happens, it might be wise to convert the debt to stock if the indebtedness makes the balance sheet look poor.

Risk of complete loss

If the venture is a long shot with a good chance that it will never get onto its feet, the election gives the protection of limited corporate liability with the opportunity to get the loss as ordinary and without argument as to the year of worthlessness. Incidentally, don't forget that in the new section on losses from small business (Section 1244) stock may be the answer in providing for a tax benefit if there is a loss for a corporation that can't qualify for the election not to be taxed as such.

Avoiding partnership restrictions

We tend to think of a corporation's electing not to be taxed as one as being in effect a partnership. This is true only in a very general sense—actually the tax is computed under the new Subchapter S, not under the partnership sections. That means that the partnership rules limiting choice of fiscal years, for example, do not apply to the electing corporation. Nor do all the elaborate rules concerning contributed property and distributions. Of course, if those provisions would give the wanted tax result, an ordinary orthodox partnership will be the answer.

However, one of the restrictions on partnerships is written into the new Subchapter S. That is the family partnership provision. Section 1375(c) provides "Any dividend received by a shareholder from an electing small business corporation . . . may be apportioned . . . by the Secretary . . . between or among shareholders who are members of such shareholder's family if he determines that such . . . allocation is necessary in order to reflect the value of services rendered to the corporation by such shareholders. This language, providing for apportionment, but only among shareholders, raises the intriguing possibility that a father might have no stock interest at all (apparently he could be a creditor if he wished) in a corporation owned by his children which he runs for them. Technically, the allocation under this section could not be applied to him because he would not be a shareholder. Nor would the broader mandate of Section 482 apply. That section says "In any case of two or more organizations, trades, or businesses (whether or not incorporated) . . . owned or controlled directly or indirectly by the same interests, the Secretary . . . may distribute, apportion or allocate gross income, deductions, credits or allowances between . . . such organizations, trades or businesses if he determines that such distribution . . . is necessary to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

One situation in which the standard advice has been "incorporate" is the business that will need all of its funds for expansion. There would be no point in having it a partnership—the owners would have to pay tax on profits they could not use because the firm needed them so badly. This firm clearly won't want to elect not to be taxed as a corporation.

If reasonable salaries for the owner-operators can draw off most of the expected profits, the classic advice has been to incorporate. There will be the non-tax advantage of incorporation,

plus only one tax—that on the salaries. This is usually a practical solution only if the owners have little income from other sources. If they do have other income, it is necessary to do some figure work to be reasonably sure that the personal income tax brackets are not higher than the corporate tax brackets would be. If the actual income turns out to be other than expected and corporate taxes go up, an election might be an out.

There is considerable room for careful planning in the interrelation of salaries to distributed losses in a corporation electing not to be taxed as one. If we are dealing with a one-man business incorporated and electing, then increasing the salary increases the loss, offsetting each other on the stockholder's return. The cash salary withdrawals are in effect return of his own investment and reduce the stock basis. Indeed, one of the extraordinary situations in which a one-year election (i.e., elect and then terminate or revoke) could be useful is the year of an extraordinary loss. If additional salary will increase the loss passed through, it might well be a method of withdrawing funds without immediate tax cost.

Many of the most difficult tax problems center around the attempt to avoid double taxation when assets held inside a corporation can be sold at a profit. Although the corporate tax might be capital, the net remaining, if paid out as a dividend, would bear ordinary tax. Avoiding the two taxes frequently involves liquidation prior to sale of the asset. Not only is this troublesome and expensive, even with the special rules on liquidations within 12-months which do not involve the corporate tax; preliminary spin-offs are sometimes required to separate assets to be sold from those to be retained. For a corporation which can qualify, election not to be taxed as a corporation in the year of sale might be a simple solution. Indeed, a corporation liquidating under Section 337 (no corporate tax on sales within 12 months of adopting a plan of liquidation) might well elect not to be taxed as a corporation just as insurance against an inadvertent failure to qualify under 337.

Subchapter S is not available to corporations which receive over 20% of their gross receipts from royalties, rents, dividends, interest, annuities and gains from sales or exchanges of stock or securities. The ordinary real estate corporation with its large rent income will not be able to qualify. However, in a year in which a substantial property is sold, gross receipts from that sale may be so large that rents are not 20% of the gross. It may be desirable to elect not to be taxed as a corporation for that year.

Corporations holding appreciated property which are restrained from distributing it to their stockholders (and the stockholders who are restrained from selling the stock of the corporation) by the threat of collapsible treatment are studying this new law with particular care. The general opinion is that, if the corporation could sell the property and elected not to be taxed as a corporation in the year of sale, double tax would be avoided. If a capital asset is involved (or if the gain is treated as capital), then it will be capital gain to the stockholders also. The Treasury is reported to be much concerned about this possibility and will fight it.

If the electing corporation suffers a loss, it is pro-rated among the stockholders and is a deduction on their returns and may be carried forward and back in the usual way except that no carryback may be made to years beginning before January 1, 1958. Thus a corporation expecting to show a loss for the year 1958, but which has profitable years to which it could carry it back, should consider carefully whether it can make better use of the loss than the stockholders. True, they can offset it against their other income, but that may result in less tax saving than applying it against the corporation's own prior-year earnings. The best answer can be determined only by careful use of pencil and paper. Don't forget the vital distinction between a corporate refund, frequently available to the stockholders only as a dividend, and the stockholder's personal tax reduction, which is spendable money with no further tax.

The rules about consent of stockholders may provide protection against the somewhat rigid rules about termination. The election can be revoked (if all stockholders at revocation consent) for a particular year only if that decision is made within the first month of the year. Suppose the first month has passed and it later becomes clear that taxation as a corporation would be desirable. It is too late to revoke, but a change in the stockholders or capital structure might work automatic termination. The election not to be taxed as a corporation terminates if the corporation ceases to qualify. Bringing in an 11th stockholder, or having a trust or non-resident alien as shareholder, or issuing stock of a new class will make the corporation ineligible and terminate the election.

Contrariwise, an unplanned automatic termination will bar a new election for five years. This promises to be a fearsome tax trap for the unwary. Note that these provisions put a potent weapon in the hands of a dissident stockholder. His transfer of some of his stock to enough individuals to bring the total stockholders to 11 can work an automatic termination. Corporations worried about this possibility are considering revisions of their restriction-on-transfer agreements to cover this possibility. In most situations it is likely that the self interest of the stockholders will lead them to act unanimously. ☆

How to make election to avoid corporate tax under new Subchapter S

by GERALD J. ROBINSON

The new law just enacted enabling stockholders in close corporations to avoid corporate tax requires exact compliance with certain specific rules. These rules are finely drawn; violation of them, inadvertent or not, can produce serious tax consequences. This article explains the provisions, discusses the very brief Regulations which have just been issued, and tells how to apply the new law.

THE TREASURY HAS ISSUED (T.D. 6317) temporary regulations covering the requirements which a corporation must meet to qualify for the privilege of not paying corporate tax. The privilege is canceled if at any time after election the corporation fails to fulfill the requirements. Any domestic corporation which is not a member of an affiliated group and has 10 shareholders or fewer qualifies so long as it has no more than one class of stock and no shareholder

who is not an individual (other than an estate) or a non-resident alien (Reg. 18.1-1).

The election can be made only with the consent of all the shareholders and must be made in the first month of or in the first month preceding the taxable year. However, for 1958, up to 90 days after enactment (9/2/58) are allowed for the election and this allowance extends to any corporation whose later taxable year includes the enactment date.

Last dates for making the election not to be taxed as a corporation are as follows:

Calendar years: 1958, before 12/2/58; 1959 and later, before Jan. 31 of year elected.

Full fiscal years: Beginning 2/1 through 9/1/58, before 12/2/58; Beginning 10/1/58 and later, before end of first month of year elected.

Short fiscal years: Begining 1958 prior to 9/3 and ending prior to 9/2/58, before 12/2/58; ending 9/2 to 12/1/58, before close of short year; ending 12/1 to 12/31/58, before 12/2/58; Beginning after 9/2/58, before end of first month of year elected.

If a corporation does not qualify as of the beginning of its taxable year, it may properly make the election if at the time of enactment it was qualified (Reg. 18.1-1(b)(2)(ii).

The consent must be given by the shareholders of record who were such on the first day of the first taxable year for which the election is effective if the election is made on or before the first day of the year. For election made after that first day (e.g. during the first month), the consent must be given by the shareholders who were such on the day when the election was made.

The election is accomplished by the corporation's filing Form 2553 containing the information required by this form and by the shareholders' filing a statement of consent. If the Form 2553 is not available, the election may be made by filing a statement containing the information required by Form 2553. Copies of Form 2553 or a description of the information required by such form will be furnished by District Directors upon request. Form 2553 must be signed by the person or persons authorized to sign the return of the corporation and filed with the District Director to whom such returns are sent. The shareholders' statement must be signed by each of them and state their consent, the name and address of the corporation and of each shareholder, the number of shares owned by each and the date or dates on which such shares were acquired. Reg. 18.1-1(b)(3)(i).

If any of the requirements for qualification are not met at any time after the election, the election ceases to be effective. For example, if a non-resident alien becames a stockholder, the corporation loses the privilege. In other words, termination occurs if the corporation ceases to qualify as a small business corporation. Terminations are not covered in the preliminary Regulations.

The law provides for termination of the election upon the failure to meet any of the requirements for qualification. In addition, the election is lost if a new individual becomes a shareholder and does not consent to the election. Termination also occurs if all the shareholders consent to the revocation of the election.

The source of the corporation's income is important as it may result in a termination. If it derives more than 80% of its gross receipts from sources outside the United States, or if more than 20% of its gross receipts are derived from interest, dividends, rents, royalties, annuities and net gains from sales or exchanges of stock or securities, the privilege is lost.

Should termination or revocation occur, the corporation (or any successor) may not make a new election until the fifth year succeeding the year when termination occurred. (However, a new election can be made before the fifth year if the Commissioner consents.) This limitation is intended to prevent corporations from electing in and out of the new provision.

Undistributed and distributed income

The corporation's "undistributed taxable income" is its taxable income minus dividends paid out of earnings of that year. For example, if a qualifying corporation with ten equal stockholders has taxable income and earnings and profits of $100,000 and during the year distributes $80,000, the "undistributed taxable income" for the year is $20,000. This amount is includible in the gross income of the stockholders in proportion to their interests in the corporation. In this case each would include $2,000. "Undistributed taxable income" is not lessened by distributions in kind or distributions of funds from accumulated earnings and profits. For purposes of the new privilege, the corporation's taxable income is computed without regard to the net operating loss deduction or in the following deductions for partially tax-exempt income and dividends received: partially tax-exempt interest (Sec. 242 IRC), the exclusion of 85% of dividends received (Sections 243, 244, 245, 246, 247).

The "undistributed taxable income" of an electing corporation is includible in the gross income of shareholders who were such on the last day of the taxable year of the corporation. The amount to be included is the amount the shareholder would have received as a dividend if on the last day of the corporation's taxable year it had distributed to him his pro rata share of the "undistributed taxable income." This is illustrated in the above example. The date on which the shareholder is deemed to have received the income is the last day of the corporation's taxable year. Using a corporate fiscal year different from the stockholder's tax year may be a useful device to defer taxation of the income.

Distributions of dividends are taxed as such to the recipient. However, if the distribution was previously taxed as "undistributed taxable income," it will be considered a distribution which is not a dividend so long as the earnings and profits are not reduced. In other words, previously taxed undistributed income is tax free when later distributed if it was income actually taxed in a prior year. Thus, whether distributed or not, the corporation's income is taxed only once and only at individual rates.

As noted above, the dividend credit and exclusion are not available to shareholders in an electing corporation, nor is such income taken into account for the purpose of the retirement income credit.

It should also be noted that provision is made for the reallocation of income among members of a family group if the Commissioner believes such reallocation is necessary to reflect the value of services rendered by family member shareholders. This prevents the avoidance of tax by a family member in a high bracket who might otherwise be able to direct income to another family member in a lower bracket by a shareholding arrangement unrepresentative of

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their respective services to the corporation.

Generally the corporation's taxable income is treated as ordinary income to the shareholder and does not retain any special characteristics it might have had in the corporation. However, a most important exception is made in the case of long-term capital gains; they keep their character as such when passed on to shareholders. This is known as the capital gain "passthrough." Under this provision, the shareholder can treat as capital gain his pro-rata share of the corporation's net long-term capital gain for the taxable year. Such amounts cannot exceed his pro-rata amount of the corporation's taxable income for the year. The passthrough provision does not apply to the corporate capital loss.

Operating losses

The capital gain passthrough allows the electing corporation a privilege not available to regular corporations; another such new privilege is the operating loss passthrough. This allows shareholders to deduct their share of the corporation's operating loss.

The loss cannot be carried back to a year before 1958, nor does corporate loss before the year of election carry over to a shareholder in an election year. The loss is computed on a daily basis so that a shareholder who sells his stock during the year will be entitled only to his proportionate share of the year's loss for the number of days he was a shareholder. For example, if an electing corporation has a net operating loss for its taxable year ending 12/31/60 of $10,000 and has had the same 10 equal shareholders for the whole year, each may deduct $1,000 on his individual return; but if on 7/1/60 a shareholder had sold his shares to an outsider, such shareholder would be entitled to deduct only $500 and the other $500 would be deductible by the new shareholder.

The operating loss passed through is deductible, but the amount of the deduction is limited to the adjusted basis of the shareholder's interest in the corporation. In other words, he cannot take a deduction in excess of the total of the adjusted basis of his stock and any debt owed to him by the corporation. If his current income is not sufficient to absorb all of his share of the loss, he is entitled to an operating loss carryback or carryover. The electing corporation is not allowed a net operating loss deduction.

This passthrough provision will provide substantial help since it will enable advantage to be taken of losses where it was not previously possible. Shareholders of corporations which have losses in earlier years, but which have no way to offset these losses against taxable income at the corporate level may take advantage of such losses by offsetting them against their own other income.

Adjustment to basis

In order to prevent the shareholders in electing small business corporations from getting double advantages from the new law, certain adjustments to stock, indebtedness and earnings and profits are required.

The adjustments to stock and debt are required so that the shareholder's basis always accurately reflects his financial stake in the business. Thus the basis of the shareholder's stock must be increased by the amount of any of the corporation's earnings which have been taxed to him but not distributed to him. In effect, it is as if his share of the undistributed income had been distributed to him and he had reinvested it. It follows that his basis is reduced if these taxpaid earnings are later distributed to him.

The basis of the shareholder's stock is reduced for any corporate operating losses which are passed through to him. However, he may not deduct for an amount of loss in excess of his basis for the stock; that is, he cannot reduce his basis below zero. If indebtedness is owed by the corporation to the shareholder, the basis of such indebtedness may also be reduced by a passed-through operating loss, but the loss must first be applied against the stock. Only the excess of the loss after the basis of the stock is reduced to zero can be applied to the debt.

While accumulated earnings and profits must be reduced as of the close of the corporation's taxable year by the amount of "undistributed taxable income" required to be included in the gross income of the shareholder (to avoid double tax), certain other adjustments to earnings and profits are not permitted. The current year's earnings and profits cannot be reduced by any amount which is not permitted as a deduction in computing the corporation's taxable income for the year. This rule prevents the reduction of current earnings and profits by costs and/or losses which would not ordinarily be deductible. Further, earnings and profits and accumulated earnings and profits are not to be affected by any item of gross income or any deduction used in calculating the amount of any net operating loss. Without this provision earnings and profits could be reduced at the same time the shareholder receives a deduction for the loss. It would then be possible, since the earnings and profits were reduced, for the shareholder to withdraw earnings in the form of a tax-free return of capital, thus resulting in a double advantage.

Returns

In spite of the fact that an electing small business corporation does not have to pay income tax, it must still file a return. The return must show the corporation's gross income and allowable deductions, the names and addresses of stockholders who were such at any time during the taxable year and the number of shares owned by each, the amount of distributions of any kind during the year and the dates of such distributions. ☆

Attribution rules intolerably complicated; Tax Bar seconds Mills Group proposals

FEW SECTIONS of the 1954 Code have caused more confusion than Section 318, dealing with the constructive ownership of stock. This is the conclusion of the ABA Section of Taxation Committee on Corporate Stockholder Relationships. It urged that the Taxation Section recommend that Congress adopt most of the changes proposed by a group of eminent practitioners to the Mills Subcommittee on Internal Revenue. The Section, meeting in Los Angeles, agreed; it approved amendment of Section 318 in many areas.

Although the general principle underlying Section 318 may be sound, experience has shown that the Section as presently drafted is confusing in many respects and is badly in need of clarification. "There was no counterpart to Section 318 in the 1939 Code," the Committee noted, "and it was intro-

duced in the 1954 Code to give explicit statutory authority to the view maintained by the Treasury Department that, in determining the tax treatment of stock redemptions, a family should be treated as an economic unit, and that beneficial rather than legal ownership of the stock should be the criterion."

Proof of hostility

The mechanical attribution rules can work serious injustice when the related parties are in fact independent or even hostile. The Committee considered proposing an exemption in such cases, but found it too difficult to draft it in satisfactory language. A new provision, the Committee said, dealing specifically with cases in which attribution is not warranted as a factual matter, was considered. The tentative wording was: "No stock shall be attributed from one adult individual to another adult individual by application of paragraph (A), if it is established by the clear preponderance of the evidence that: (i) he neither controls, or is controlled by, the actual owner of such stock, (ii) he has no reasonable expectation as of the time of the application of this Section of receiving such stock from the actual owner, directly or indirectly, by gift, inheritance or otherwise, and (iii) the normal bonds of family relationship do not exist between such individuals with respect to such stock."

The Committee concluded, however, "that in view of the unusual nature of the tests of 'control' of one adult individual by another, expectation of receipt of the stock by one person from another, and absence of 'normal bonds of family relationship,' it would be preferable to leave the matter to the broad language of Section 302(b)(1) ('not essentially equivalent to a dividend') which has been in the statute for many years.

"The amendments proposed in Sections 5, 6 and 7 of the above resolution would modify provisions in Sections 304(b)(1), and 304(c) and 382(a)(3) which in present law provide in certain special cases for attribution of stock from a shareholder to a corporation whether or not he owns 50% or more of the stock of the corporation. Under the amendments a 5% minimum stock ownership would be required for such attribution in those special cases.

"The principal change from the recommendations made by the Mills Advisory Group on Subchapter C relates to the matter of attribution to grandchildren of stock owned by grandparents. The present Code requires that the stock owned by their grandchildren be attributed to grandparents, but does not require that the stock owned by their grandparents be attributed to grandchildren. The Mills advisory Group recommended an amendment of Section 318 to require attribution in both directions. In the present recommendation the statute would remain in its present form in this regard, and stock owned by grandparents would not be attributed to their grandchildren."

The Committee proposal to leave the situations where there is actually no control to the escape hatch provided by the "not essentially equivalent to a dividend" provision would be effective, of course, only if another proposal is adopted making it clear that the attribution rules do not apply to the "essentially equivalent to a dividend" exception.

Essentially equivalent to a dividend

It is the Committee's position that, in applying the attribution rules of Section 318 to determine whether a distribution is essentially equivalent to a dividend (Sec. 302(b)(1)), the IRS is misconstruing the intent of Congress. Consequently it recommends that Congress amend the Code to make its intent explicit. If that is done, then the "essentially equivalent to a dividend" test will provide the relief from the arbitrary attribution rules which Congress originally intended.

"It is believed," the Committee says, "that Section 302(b)(1) was intended to provide an escape in cases in which the arbitrary rules of Section 318(a) produce inequity because there is no real identity of interest between the parties who are technically within the attribution area and there is no proper justification for attribution of stock ownership between them. The amendments proposed would specifically provide that the constructive ownership rules of Section 318(a) shall not apply in determining whether the redemption is not essentially equivalent to a dividend within the meaning of Section 302(b)(1), but that, for the purpose of that determination, the relationships described in Section 318(a) may be taken into account along with all other facts and circumstances.

"Under Section 318 as presently drafted," the Committee said, "extremely difficult and confusing problems have arisen because of the requirement that stock be re-attributed into and out of partnerships, trusts, estates and corporations. For example, stock owned by a partner is treated as owned by any partnership of which he is a member, and, according to the literal language of the statute, the stock thus constructively owned by the partnership is again attributed to the other partners in proportion to their interests in the partnership. Similar re-attribution takes place among co-beneficiaries of trusts and estates and stockholders of corporations.

Because of this re-attribution, it is possible, theoretically at least, that ownership of stock could be attributed to a person who had no knowledge of nor economic connection with the actual owner of the stock. In the proposed revision, this re-attribution is eliminated. . . . A 5% limitation is provided for in all cases, so that persons having small interests in corporations, partnerships, trusts and estates will not have to bother with the attribution rules.

"Under present law the method of computing the proportion of ownership of a corporation by a shareholder is based on the value of the stock owned, directly or indirectly, by the shareholder, and stock presumably includes preferred stock owned by the shareholder. Under the proposed revision, preferred stock is specifically eliminated from the computation of value.

"Stock owned by a partnership is attributed 'proportionately' to the partners, but present Section 318 does not state how this proportion is to be measured. [It is] proposed that the proportion [be] based on either interest in profits or in capital of a partnership, whichever is greater.

"Under present law attribution to a beneficiary of stock owned by a trust is made in accordance with the beneficiary's actuarial interest in the trust. However, attribution to a beneficiary of stock owned by an estate is made in accordance with the beneficiary's present interest in the estate. In the interest of consistency, [it is] proposed [to] treat estates and trusts alike for purposes of determining the proportionate interests of beneficiaries by providing that in both instances the proportion is to be determined on an actuarial basis.

"Where stock owned by an estate has been specifically bequeathed to certain beneficiaries," the Committee proposal

is that, "This stock should not be attributed to other beneficiaries and should be attributed only to the beneficiaries to whom it has been specifically bequeathed. Likewise, it is provided that, where a beneficiary of an estate is specifically bequeathed property other than the stock in question, the stock should not be attributed to that beneficiary, but should be attributed exclusively to the other beneficiaries in proportion to their interests in the remainder of the estate excluding the property specifically bequeathed." ☆

Thin incorporation today: practitioner's guide through judicial confusion

by **BERNARD A. GREENBERG and FREDERICK L. SIMMONS**

Tax men are finding that the innovations in the 1958 legislation haven't solved the thin incorporation problem. Electing to be taxed as a partnership may be impossible or undesirable and the possibility of an ordinary deduction for a loss on stock leaves untouched the advantage of holding debt that can be repaid at no tax cost if, as all venturers hope, the venture is profitable. Despite very many cases on the issue, the principles which the courts use to test thinness have been changing and are confused. Messers. Greenberg and Simmons recently prepared a thorough analysis of the cases and of the published comment on the problem for UCLA Law Review. For the benefit of the busy practitioner, we bring you here the article somewhat condensed and without the extensive footnotes.

THE USE OF A THIN corporation as a way of avoiding the onerous burdens of Federal corporate taxation has been severely restricted by a large body of case law. However, despite this extensive litigation, no clear standard has evolved by which to predict what will be an acceptable thin incorporation. As a result, practitioners have been obliged to evaluate their choice of corporate capital structure in terms of criteria which seem to vary with each new decision.

An unsuccessful attempt to incorporate thin imposes no immediate penalty on the corporation. The courts simply treat the shareholder's loans to his corporation as contributions of risk capital,[1] and the corporation will be denied a business expense deduction for "interest" paid on the "loan." More serious consequences may ensue as to amounts received by the shareholder as "return of principal" on the "loan" for these will be treated as dividends, and thus ordinary income to the shareholder. If large sums have already been paid during a single year, the result may be extreme tax burdens due to progressive personal Federal income tax.

These retroactive tax consequences make it highly desirable for the taxpayer to know whether a court will recognize shareholder loans to his corporation for income tax purposes. Faced with the thin incorporation problem, the courts not only have failed to provide a standard, but have rendered decisions which fail to reflect any consistent approach or single analysis. Rather, the cases indicate that the courts have evolved three general analytical devices which they apply to a thin incorporation problem. For convenience the authors term these: (1) the ratio test, (2) the business purpose test and (3) the true intent test. No one test is used exclusively, nor will compliance with any one of the three assure that a court will recognize shareholder loans. The nature and the application of these tests illustrates both the scope of the problem facing the courts and their relative inadequacy to solve the problem.

The ratio test

Probably the most familiar single element used in the analysis of a thin incorporation is the *ratio* of the corporate debt to the shareholder's equity. That is, the ratio test compares the total amount of corporate debt to net corporate capital.[2] If the ratio is excessive, the corporation may be held to be inadequately capitalized, and any shareholder loans to the corporation treated merely as contributions of risk capital. This concept, that there are automatic juridical consequences of a disproportion of debt to stock, was apparently analogized from the use of a ratio test in credit management. Despite objections to the application of this analysis to tax litigation, the ratio test has become a basic concept in the literature in this area. Although some writers have put primary emphasis on the ratio, a few have recognized that the ratio of debt to stock is merely *one* factor to be considered. But from the cases it is difficult, if not impossible, to determine any standard of an acceptable ratio. Although ratios of as high as 9:1 have been accepted by the courts, a recent case overturned a ratio of 1:1 and the absence of any ascertainable standard has led some courts to reject the ratio test entirely. It would seem that, in the absence of legislation or a definite set of regulations, a ratio test which is absolute and capable of mechanical application to a given set of facts will not be available. Probably all that can be said for sure is that at a certain point a grossly disproportionate ratio of debt to stock will be held to be merely a sham transaction.

The "business purpose" test is merely a specific application of the axiom that transactions, no matter in what form, may be disregarded if they are sham or masquerade. It had its birth in the requirement of some business purpose, other than mere tax minimizing, in the taxpayer's choice of the new corporate structure in a corporate reorganization. The application of the doctrine to analogous areas of tax litigation has been somewhat limited since the courts have indicated that, if there was some authentic non-tax purpose in the choice of corporate structure, the mere presence of a tax avoidance factor will not invalidate the transaction. However, the business purpose doctrine has two possible applications to the problem of an acceptable thin incorporation. First, the Commissioner may argue that there must be a business purpose in the taxpayer's initial decision to incorporate his business. Second, the Commissioner is apparently arguing that there must be a business purpose in the choice of the particular capital structure employed. Recent cases suggest that Commissioner's arguments have not been successful; however, the rather nebulous business purpose doctrine still represents a con-

stant threat to the taxpayer who is considering incorporating thin.

The basic objection to the extension of the business purpose doctrine to this area is that such a test creates one more subjective "intent factor" which is determinate of tax liability. Whether the business purpose doctrine will be extended to the field of thin incorporation will probably depend on the effectiveness of a third test or analysis which the courts have recently developed — the true intent test.

The true intent test

Under the "true intent" test, the court examines the shareholder's loans to his corporation to see if a true debtor-creditor relationship was intended. The court, of course, looks to the more obvious elements tending to show bona fides of a loan, such as: (1) the form of the instrument, (2) the time of making the advances, (3) the presence or absence of a definite maturity date. (4) the superiority or inferiority of the shareholder's loans to other corporate obligations, (5) the interest factor—whether the obligation to pay interest is contingent, (6) the principal factor—whether the obligation to repay the sum advanced is positive and unconditional, (7) the collateral factor—whether the loans are secured, and (8) the disproportionate factor—whether the debt is directly proportional to the stock interest of each shareholder. However, recent cases have apparently required *something more* than mere compliance with technical or clerical formalities to determine whether a true debtor-creditor status was intended. Just what will constitute this *something more* is subject to some question. Need the shareholder have the mind of an outside creditor, ready to put the corporation out of business in the event of business difficulties? Will proof of circumstances personal to the shareholder indicating a purpose distinct from and adverse to that of the corporation suffice? Is an examination of the *use* to which the funds contributed were actually put to be controlling? And finally, must satisfactory evidence of true intent be contemporaneous with loans at the time of the initial incorporation, or may it be supplied by subsequent acts? To date, there is no definite answer that can be given to these and similar questions raised by the application of a true intent test to the thin incorporation problem.

Modern corporate theory, which begins with the premise that the contribution of a minimum base capital, adequate for the risk involved, is necessary to enter into business in the corporate form, may provide one analytical tool with which to examine the real nature of the transaction and the exact relationships involved in a thin incorporation. The thin incorporation device is designed to allow the *shareholder* to provide part of the funds which the corporation requires in the form of a loan, which will be repaid to him as the earnings of the business create a surplus. That there is judicial concern with the anomalous dual status of the shareholder who is both owner and creditor of the same business is reflected by the business purpose and true intent tests, in which the courts have focused their attention on the subjective *intent* of the parties. An examination of shareholder loans in terms of the adequacy of the risk capital invested would provide an *objective* standard, divorced from the intent factor, with which to solve the thin incorporation problem. If there is a sufficient investment *as capital* to engage in *this* business then there should be no objection to shareholder loans. If there is not a sufficient capital investment, then shareholder contributions in other forms should be treated as invested capital to the extent necessary to have an adequate risk contribution. Any withdrawals by the shareholder above this necessary base capital should be treated as dividends regardless of the labels employed because they represent a return on the capital contribution required as a condition of corporate existence. Following this suggestion, for tax purposes, as in corporation law, the shareholder can be a bona fide creditor of his corporation only to the extent it is adequately capitalized.

Of course, the question of just what is adequate capitalization is one of the most complex questions of law and fact which a court must answer. It has been suggested that a modified ratio test would aid in an objective determination. One approach would be to compare the business under question with others similarly situated and decide if the shareholder's capital investment is large enough to run a business of the size and nature of the one in question. A second approach would involve a determination of whether the *corporation* could have obtained the amounts provided by shareholder loans from a commercial credit source—in effect leaving to the money market the decision whether the proportion of debt to stock is appropriate. The objection to these proposals is that the result will be a case by case determination which will not provide any definite rule for the guidance of other taxpayers. Their virtue is that the judicial inquiry is focused on the soundness of the corporate capital structure rather than on the personal intent of the parties.

This type of objective analysis has been employed in non-tax litigation involving the recognition of shareholder loans as against the claims of third party creditors of a now insolvent corporation. In the tax cases involving thin incorporations, however, the courts have not analyzed the corporate structure apart from the intent of the parties. And from the trend of the decided cases, one must conclude that there is no shareholder debt which will be free from the possibility of contest by the Commissioner.[1]

If the attorney's sole object is to keep his client's transactions free from question, he may be well advised to forego

[1] E.g., Gooding Amusement Co., 236 F.2d 159 (6th Cir.) *cert. denied* 352 U.S. 1031 (1956); R. M. Gunn, 25 TC 424, 438 (1955); Erard A. Mattheissen, 16 TC 781 (1951); *Cf.* Emmanuel N. (Manny) Kolkey, 27 TC No. 4 (1956). To the present time the cases have dealt with the debt as a whole and found the entire sum to be either a debt or a contribution of risk capital. There would seem to be no reason why a portion of the amount contributed as a loan cannot represent true debt in an otherwise unacceptable thin incorporation. It has been suggested that the corporate draftsman, therefore, should divide his debt into classes or layers and, if faced with a contest, argue that the court should determine the proportion or ratio it feels is valid.

[2] There is some question whether the entire corporate debt should be computed in arriving at the ratio or whether only shareholder debt should be considered. Since the ultimate determination is whether the corporation has a sound capital structure, it would seem reasonable to consider the entire corporate debt. There is also some question whether the ratio is to be computed on only debt coincident with the incorporation or on the amount of debt existing at some later time. It has been suggested that only initial debt should be considered, since, if a corporation is adequately capitalized in inception, later financial reverses will not subject the shareholders to personal liability. However, if the incorporators anticipated that shareholder loans would be necessary at a later time, there would seem to be no reason not to include these credit obligations in any ratio calculation. Rev. 355 (1952). *But cf.* Warren H. Brown, 27 TC No. 3 (1956) where the tax court found that assets transferred to a business were sufficient to carry on one part of the business marketing) even though the corporation later required loans from shareholders to engage in the logging and milling operations in which it ultimately decided to engage.

There is also some question as to how to value corporate assets in computing the ratio of debt to equity. Some writers suggest computing the ratio on the basis of par value of stock plus surplus. The suggestion seems reasonable since the outside creditor will look at *all* of the shareholder's equity to determine the protection afforded his investment. Unrealized appreciation may be considered in computing the equity. *Cf. Estate of Miller*, 239 F.2d 729 (9th Cir. 1956) in which goodwill was included in the valuation of the shareholder's equity. To decide whether a corporation is adequately capitalized, the court will look to the actual value of the corporate assets, not book value.

the use of shareholder debt or its equivalent in the corporate structure. However, considerations of sound business and credit management often demand shareholder advances in the form of credit contributions, and in such a situation the adviser may justifiably consider the use of shareholder debt despite the possibility of contest by the Commissioner.

In such a case, he should consider the proposed transaction in terms of the three analytic devices employed by the courts.

Problems of the adviser

First, he should consider the ratio between debt and stock. Although the ratio of itself is not conclusive, a high ratio will certainly raise a serious question, and a ratio of debt to stock in excess of 2:1 gives little advantage compared to the risks involved. Second, the adviser should consider the availability of evidence of a "business purpose" in the choice of the corporate form of business organization and also in the choice of the particular capital structure employed. Third, he should consider the availability of evidence of a "true intent" to create a debtor-creditor relationship distinct from that of the shareholder status. That is, is there evidence that a loan transaction was motivated by personal rather than corporate advantage?

Considering the transaction in the light of these tests, he can make an intelligent estimate of the probability of an adverse holding by a court to the effect that the shareholder loans were simply capital contributions. Then, and finally, the adviser must decide whether the possibility of such a holding, with its consequent tax disadvantages, would make the shareholder's advance in this situation an unwise business decision. That such ratiocinative processes are required is one more proof of the complexity of modern tax law. ☆

IRS attacks incorporation of part of architects' partnership

WHEN PROFESSIONAL MEN achieve success (and the higher tax brackets), they often wish they could do business as a corporation, with its lower rates, ability to accumulate profits for capital improvements and expansion, and possibility of liquidation or sale. In one such attempt, now before the Tax Court (*Stickle*, Docket No. 73123), the size of the asserted deficiencies indicates that the partners were in very high brackets indeed.

They were a firm of architects with a nationwide practice. They formed three corporations to do designing, drafting and inspecting services as subcontractors for the partnership. They cite as business reasons their wish (1) to limit their personal liability, (2) to reduce their unemployment tax liability, and (3) to provide continuity in the event of the death of one or more partners.

The Commissioner claims that the income of the corporations is in reality income of the partners, citing Section 482, which requires scrutiny of transactions between related interests and permits him to distribute, apportion or allocate income or deductions between or among them if this is necessary in order to prevent evasion or clearly to reflect income.

In addition, he argues that the corporations come within the scope of Section 269, which disallows any deductions, credits or other allowances if "avoidance" of tax by getting the benefit of such allowance was the principal purpose of acquiring a corporation.

Undoubtedly the Commissioner will rely upon the decision in *Advance Machinery Exchange* (196 F.2d 1006 (Second Circuit, 1952)). Here an individual organized three corporations to deal in used machinery and acted as an officer and director of the three corporations while engaged in the same business as a single proprietor. All three corporations and the proprietorship used the same premises, the same equipment and the same employees and to a large extent served the same customers. The income from all four businesses was held to be properly taxable to one of the corporations.

There are other cases, however, (e.g., *Friedlander Corp.*, 216 F.2d 757 (Fifth Circuit, 1954) and *Miles-Conley Company*, 10 TC 754 (1948) *Acq.* 1948-2) in which the Commissioner has been denied the right to reallocate under Section 482. Where the business of the corporation and the business of stockholders are in fact separately maintained, no combination of income may be made even though the businesses are related.

Thus the question at issue in the *Stickle* case would seem to be whether the facts justify the Commissioner's allocation.

In other words, was the income of the corporations other than what it would have been if these corporations had not been controlled by the partners? ☆

3-year wait may avoid collapsible tax

UNDER THE 1939 Code there was always a question as to whether the assets distributed in complete liquidation of a corporation which were subsequently sold by the shareholder-recipients were in fact sold by the liquidated corporation, so that the Commissioner could impose a tax at the corporate level on the sale. This became known as the *Court Holding Company* problem (*Court Holding Company*, 342 U. S. 331 (1945)).

The enactment of Section 337 of the 1954 Code, which provides for nonrecognition to a corporation of gain or loss on its sales or exchanges of property made within a 12-month period following the adoption of a plan of liquidation, was intended to dispose of this problem. However, a recently issued ruling, *Rev. Rul.* 58-241, is a reminder of one frequently-occurring situation involving a collapsible corporation in which Section 337 may not be availed of to avoid a gain at the corporate level. To illustrate, a real estate corporation constructs an apartment house dwelling and then for a period in excess of three years is engaged exclusively in the rental of this property. After the lapse of this period, if the shareholders determined to dispose of this real property, Section 337 could not be safely employed to avoid the tax at the corporate level because the corporation might be deemed to be collapsible.

This is because of the way the Code is written. A collapsible corporation is excluded from the benefits of 337 and a corporation does not necessarily lose its collapsible character after the expiration of the three-year period. Thus, after three years, the real estate corporation might be determined to be collapsible and outside Section 337 even though Section 341(d)(3), which exempts from collapsible treatment the gain realized after the expiration of three years following the completion of construction, would otherwise permit the shareholders to avoid the collapsible treatment by either liquidating the corporation or selling their shares. Therefore, if the shareholders in this situation were to sell the realty shortly after the corporation's liquidation, the old *Court Holding Company* prob-

lem would be posed. [In the above illustration, consideration has not been given to the newly enacted Section 341(e).—*Ed.*]

A typical *Court Holding Company* case situation was recently docketed in the Tax Court (*Rosmoyne Realty and Building Company,* Docket No. 72778), wherein the Commissioner alleges that a corporate liquidation in kind of realty, thereafter followed some three months later by the recipient shareholder's transfer to a purchaser, in essence constituted a sale by the corporation. The issue to be resolved would appear to be a factual one, whether the corporation had instituted the negotiations leading to the sale. ☆

New corporate decisions this month

Officer-stockholders' salaries allowed as reasonable. The Commissioner challenged as unreasonable the compensation paid three of taxpayer's officers who were principal stockholders. The officers each received $18,000 a year plus 15% of the net profits. Considering competitive salaries and the contribution of these officers to taxpayer's business, the court concludes the compensation was reasonable. In reaching this decision, the court was influenced by the fact that the retirement pay provided for these officers was less than competitive firms would pay. The Commissioner also disputed the method of computing the 15% profit shares, but the court approves the taxpayer's computations as reflecting the intent of the agreement. *Wilson-Weesner-Wilkinson Co.,* DC Tenn., 8/4/58.

Bargain purchase by stockholders a dividend. Three families held the stock in a corporation organized to sell gift parcels for delivery in Italy. Due to personal differences, one family was bought out in September 1946, the corporation paying about $380 a share. A month later these shares were sold to the remaining stockholders and an employee for $200, the amount the company accountant computed as their book value. The purchases were not quite pro rata. A year later the second family and the employee were bought out at about $680 a share, again the corporation being the purchaser, and the shares sold to the remaining family at $1 a share in such amount as to leave father and son each owning half. The court finds that the bargain purchases were dividends and determines the fair market value of the shares so sold. *Scura,* TCM 1958-161.

Spin-off without business purpose a dividend. An automobile dealer company owned all of the stock of a realty corporation which owned the building in which the parent, the dealer, operated. Later, all of the stock of the wholly-owned real estate subsidiary was transferred to a newly created subsidiary, and the new subsidiary's stock was immediately transferred out to the sole stockholder of the dealer. This was done primarily to enable the stockholder to meet his obligations under a divorce settlement. Although the plan followed the form of a corporate reorganization, the court holds the plan had no "business purpose" and constituted a taxable dividend distribution to the stockholder. *Bondy,* 30 TC No. 110.

Parent merging with subsidiaries into new corporation need not file separate return. A corporation desiring to reincorporate in another state and operate directly the assets of its two wholly owned subsidiaries adopted a reorganization plan whereby it formed a new corporation under the laws of the desired state and then merged with the subsidiaries into the new corporation as survivor. The merger of the former parent and the new corporation is held to effect a mere change in place, so that the former parent is not required to file a separate return for any part of the year prior to the reorganization. *Rev. Rul.* 58-422.

Use of excess mortgage funds to redeem preferred renders corporation collapsible. Taxpayers formed eight corporations with redeemable preferred stock to construct rental properties. The cost of construction turned out to be less than the FHA mortgage loan proceeds, and the excess proceeds were used to redeem the preferred. The court notes that these corporations were similar to others it had found collapsible and that taxpayers' arguments were directed mainly to trying to show distinctions. The court finds the corporations had been formed, or in any event availed of, with the requisite collapsible intent. Gains on the redemptions are attributable to the construction and are held taxable as ordinary income. Taxpayers also argued that a substantial part of the net income to be derived from the rental operations was received prior to the year of redemption, relying on the fact that subsequent years showed net losses. The court disagrees on the ground that the test period used, the first seven years of operations, in which interest payments were high, did not provide a fair sampling of anticipated corporate net income. Furthermore, the fact that the Commissioner's notices of deficiency did not refer to Section 117(m) (the collapsible section of the 1939 Code), but to Section 22(a) does not shift the burden of proof to the Commissioner, as the deficiencies did refer to oral statements at conferences, and taxpayers' protests, each of which adequately dealt with Section 117(m). *Payne,* 30 TC No. 111.

1 to 109 stockholder equity to debt ratio too thin. Taxpayer, a bowling alley, was incorporated with a $1,000 capital, even though it took $366,000 to start the enterprise. The stockholders in the corporation advanced in proportion to their stock interest $109,000 on unsecured notes; the balance was obtained by loans from outsiders. One of the conditions of the outsider loans was that stockholders have "an equity" of at least $90,000. The court disallows taxpayer deduction for interest on the stockholder notes. In substance the stockholder advances were capital. *Harkins Bowling, Inc.,* DC Minn., 8/22/58.

Construction corporation collapsible; distributions of excess mortgage proceeds are income. Two corporations, organized to construct housing projects with FHA loans, distributed to taxpayer-stockholders the excess of the mortgage loan proceeds over the total cost of construction. The court holds the corporations collapsible under 1939 Code Section 117(m), and the distributions taxable as ordinary income, even though the "view to distribute" the excess funds may not have arisen until after the completion of construction. Furthermore, the fact that the Commissioner did not mention his specific reliance on Section 117(m) in his deficiency notice does not help the taxpayers, since the 30-day letters and protests showed a clear intent to rely on that section, and the Commissioner did not have the burden of proof. *Sidney,* 30 TC No. 122.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

Wrong-basis taxpayers face day of reckoning under Technical Amendments Act

by **GEORGE F. SHANNON**

The Technical Amendments Act, hailed for the tax relief it brought to small businessmen, cracks down on this group severely in the provisions of Section 29, which finally aims to tax the accumulated untaxed profits represented by the inventories and receivables of cash-basis taxpayers. The majority of such wrong-basis taxpayers are small businesses. Mr. Shannon presents here an analysis of Section 29, an explanation of how it fits in with Section 481 of the 1954 Code, and recommendations for planning in order to make the best of a bad situation.

Among those whose "lot is not a happy one" are cash-basis-with-inventories taxpayers, largely because of IRS legislative activity and administrative inactivity. These taxpayers, often for many years, were permitted to accumulate untaxed profits in accounts receivable and inventories although their taxability was clearly established by accounting principles, economic fact and the Commissioner's Regulations. In the early years of this decade, IRS reversed its policy and attempted to tax these entire accumulations in the year of change, but was defeated in the courts. A legislative remedy was sought which became Section 481 of the 1954 Code and provided for the taxation of these accumulations except those attributable to years prior to the effective date of the new Code. Loss of these 1953 and prior years' accumulations apparently was considered by the Commissioner's staff too high a price to pay for its own administrative negligence. It almost completely ignored the new section, refused to apply it in accordance with congressional intent and refrained from explaining it in Commissioner's Regulations. Many taxpayers, however, relying on the new section and without obtaining the Commissioner's permission, changed their tax accounting method from cash to accrual as of the beginning of their first 1954-Code years. The "net adjustment" (accounts receivable, inventories, prepaid and accrued expenses, accounts payable) as of that date was credited directly to Earned Surplus, and the profit it represented was regarded as excepted from taxation under Section 481. Now, in Section 29 of the recently enacted Technical Amendments Act, an attempt is made to tax these profits.

Sec. 29 intent

The new section is limited in its application solely to (a) pre-1954-Code year adjustments (b) where taxpayers of their own volition changed their method of accounting in a 1954-Code year. Both conditions must exist. Assume calendar-year Corporation X, having net adjustments of $300,000 at December 31, 1953, and $325,000 at December 31, 1954, on its own initiative changed from cash to accrual as of the latter date. Section 29 would apply to the $300,000, but not to the $25,000 increase. If Corporation X had continued on the cash basis, Section 29 would not apply. Nor does it apply when the net adjustment would not increase taxable income by more than $3,000. However, if Corporation X had changed its accounting method as of January 1, 1954, the new section applies even if additional assessment for that year is barred by the statute of limitations.

This result is accomplished through the mechanics of a 10-year "spread forward," as indicated by the following excerpt from the Senate Finance Committee report:

"The intent of this provision is to make it clear, especially in the case of past years which may be closed (such as 1954), that even though the period of limitations has expired with respect to that year, nevertheless the adjustment required to be taken into account in succeeding taxable years, attributable to a change in method of accounting made in the closed year, still is required to be taken into account. This will prevent taxpayers from avoiding the adjustments with respect to open years by the circumstance that the change in method of accounting occurred in what is now a closed year."

Otherwise stated, while Section 29 does not reopen closed years to assess additional taxes in those years, it does reopen them for purposes of the spread forward. This distinction probably will not be appreciated by wrong-basis taxpayers, almost all of whom are small business men. More likely, they will conclude that a statute which has their tax relief as one of its principal purposes also includes a provision reopening the statute of limitations to clobber them.

This temporary provision, which applies only to changes in method of accounting made before January 1, 1964, prevents "bunching" of taxable income into a single year. One-tenth of the net adjustment is to be taken into account in each of ten years beginning with the year of change. Assume calendar-year Corporation Y, with a net adjustment of $200,000 as of December 31, 1953, changed its tax basis to accrual as of January 1, 1954. $20,000 of the net adjustment would be added to its taxable income for each of the ten years beginning with 1954. If additional assessment for 1954 is now barred by the Statute, the first of these $20,000 allocations would not be taxed, although the other nine would. Alternatively, Corporation Y, by a transitional rule in the new section, could elect to begin the 10-year period with 1958. This alternative allows taxpayers more time to pay the additional tax computed on their pre-1954-Code years' net adjustments. Under the general and alternative rules, the balance of the net adjustment is taken into income in the year when a taxpayer's status changes. Such changes include death of an individual, termination of a business and corporate acquisitions (except those to which Section 381 applies).

The 10-year spread forward is neither exclusive nor mandatory. Both the allocation alternatives provided in Section 481(b) of the 1954 Code continue to be available to taxpayers subject to the new section. One of these limits the tax attributable to the net adjustment to the increase in tax had the adjustment been allocated ratably to the year of change and the two preceding years. The other applies only to taxpayers whose records support an allocation of the net adjustment to years prior to the year of change. In such cases, the additional tax is limited to the increase resulting from spreading-back the net adjustment to consecutive years preceding the year of change. However, if either of these Section 481(b) allocations is used, the entire net adjustment is subject to tax.

Election to return to cash basis

Unique among new Section 29's provisions is the election in subsection (e) permitting a taxpayer to return to a former method of accounting. It is explained in the Senate Finance Committee report as being concerned with taxpayers who without obtaining the Commissioner's consent changed their method of accounting on the assumption that pre-1954-Code net adjustments would not be taken into account. Section 29 grants such taxpayers an election to recompute their taxable income for 1954-Code years on the prior (cash basis) method of accounting. For this purpose, the statute of limitations is kept open for a year after the election, which must be made within six months after enactment of the Technical Amendments Act (before March 2, 1959). Thus, calendar-year Corporation Z with a net adjustment of $400,000 at December 31, 1953, which, without permission, changed to the accrual basis as of January 1, 1954, may now file amended cash-basis returns for that and later years. Furthermore, if the tax liabilities reported are less than those on the original accrual basis returns, refund claims may be filed.

Changes without permission

What action should now be taken by Corporation Z and like taxpayers whose unilateral change in tax basis has not been challenged by the Commissioner's staff? Their planning should begin with the realization that the intent of new Section 29 is to include in taxable income all, or substantially all, their net adjustments as of the beginning of their first 1954-Code years, even if now closed. Such taxpayers, it appears, have only two choices. One is to continue filing accrual-basis returns and, when the Commissioner's staff applies Section 29, to make the best settlement possible under the 10-year spread forward provision. If application were deferred long enough, the entire net adjustment would escape taxation since the 10% annual allocations to closed years are barred from assessment by the statute of limitations.

The other alternative is to act under subsection (e) and file amended cash-basis returns for the year of change and subsequent years. These filings, it appears, make Section 29 inapplicable and place these taxpayers in substantially the same position as those who have continued to file cash-basis returns. They also bring to the attention of the Commissioner's staff unobserved "without permission" changes in closed years. Similarly, the one-year reopening of the statute of limitations enables the Commissioner to assess a tax on a portion of the net adjustment which otherwise would be barred by the statute. The first is the better of two poor alternatives.

Taxpayers who didn't change method

What now is the status of a calendar-year corporation, let us call it A, which on December 31, 1953, had a net adjustment of $500,000, continued to file cash basis returns and on December 31, 1957, had a net adjustment of $700,000? Clearly, Section 29 is inapplicable since directed exclusively at taxpayers who changed their method of accounting without obtaining the Commissioner's consent. Section 446, the general rule for methods of accounting, does apply, however, and since this Corporation's method does not clearly reflect income, it may be required, under 446(e), to use one which does. If, for instance, its calendar-year 1957 return is examined in July 1959, the Commissioner's staff undoubtedly would recompute taxable income on the accrual basis for the then open years (1956 and 1957, assuming the six-year "gross error" provision of Section 6501(e) did not apply). This process would automatically include in income the increase in the net adjustment during 1956 and 1957.

Under these conditions, 1956 would be the year of change, and the Revenue Agents undoubtedly would require Corporation A to include in that year's taxable income at least the increase in the net adjustment during 1954 and 1955. Authority to do so is provided by Section 481(a), the general rule, and more particularly by its paragraph (2), which, as amended by Section 29, is as follows:

"Section 481(a) General Rule.— . . . (2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except that there shall not be taken into account any adjustment in respect to any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer."

The additional assessment resulting from including in 1956 income the 1954-55 increase in the net adjustment would, however, be limited by the allocation alternatives stated in Section 481(b).

Tax practitioners are not in agreement on the tax status of pre-1954-year net adjustments where, as in this case, change from cash to accrual basis is required by the Commissioner. Some, relying on the "except" clause of Section 481(a)(2), quoted above, believe these net adjustments would not be subject to tax. Other than this clause, there is nothing in Section 481 which supports the view that the pre-1954-years' net adjustment constitutes a fund of untaxable income. The Senate Finance Committee's report on the 1954 Revenue Act, however, does include in its comment on Section 481 an example which indicates that some of this income may escape taxation, provided, of course, that the change in accounting method is forced by the Commissioner's staff. It says, in effect, that the net adjustment is nontaxable to the extent pre-1954-Code year items are still on the books as of the beginning of the year of change.

The example cites the case of a taxpayer, changed from cash to accrual basis in 1960, when his opening (January 1) inventory was $2,500. All of this inventory must be added to 1960 income, according to the example, if its cost "had been deducted in prior years subsequent to 1953 under the cash method . . . in order to prevent the same item from twice reducing taxable income . . ." However, if the inventory in-

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cluded $1,000 in items paid for in pre-1954-Code years, only $1,500 would be added to 1960 taxable income. Parallel reasoning applied to accounts receivable indicates that income represented by accounts receivable, too, would be non-taxable if it originated in pre-1954-Code years and the accounts were still on the books at the beginning of the year of change. Unfortunately, in Corporation A's case and that of others in similar circumstances, time works for the Commissioner. A, for example, could claim as non-taxable inventory and accounts receivable on its books as of December 31, 1953 (close of final pre-1954 Code year), and January 1, 1956 (beginning of year of change). As a practical matter, however, this inventory and these accounts, then being at least two years old, probably would have little value. Quite possibly, the beneficial operation (from the Commissioner's viewpoint) of this time factor largely explains his refusal to administer Section 481 as originally enacted. By employing rather reprehensible delaying tactics and by continuing to accept wrong-basis returns, he has placed these taxpayers in a position where Section 481 affords them little or no tax relief. Simultaneously, by legislative activitiy, he now has new Section 29, which places taxpayers who changed basis without permission in an almost equally disadvantageous position.

Closed and pending cases

Subsection (d) of new Section 29 states that it applies to any change in a method of accounting where the year of change is one beginning after December 31, 1953, and ending after August 16, 1954.

However, the subsection also states that the section does not apply if, before the effective date of the Technical Amendments Act, the taxpayer and the Secretary of the Treasury or his delegate agreed to the conditions for making the change. The Senate Finance Committee report says in this respect that any change in accounting methods already specifically allowed should not be upset by the new provision. ☆

Deducting fines and penalties: the Supreme Court rules

IN TWO CASES decided on the same day, the Supreme Court has laid down the rule for determining the deductibility of fines and penalties—it uses the "frustration of public policy" test with two possible modifications, the degree of frustration on one hand and the hardship to the taxpayer on the other. Joseph B. Bugliari in a recent note in the *Cornell Law Quarterly* (Vol. 43, page 725) analysed these cases (*Tank Truck Rentals, Inc.*, and *Sullivan*). He thought it unfortunate that the Court rejected a consideration of whether the taxpayer's violation was inadvertent.

"The general rule promulgated by the IRS and supported by the courts," Mr. Bugliari said, "is that fines and penalties imposed for violations of state or Federal statutes are not deductible as business expenses even though they may be ordinary and necessary within the meaning of Section 162 of the 1954 Code. Although Section 162 states no criteria other than 'ordinary,' 'necessary,' and 'incurred in the taxable year,' the Service and the courts repeatedly disallowed the deduction of fines and penalties in earlier cases by asserting that violations of statutes were never necessary in operating a business. Later, when this argument proved untenable, the courts concluded that, if fines and penalties were allowed as deductions, the desired effect of these statutes would be seriously impaired, with a consequent frustration of the public policy which prompted their enactment.

"The promulgation of this 'judicial gloss' established 'frustration of public policy' as the test of deductibility; just how far this test should be applied is a lively question. Former Attorney General Brownell has advocated that the full force of the Federal tax power be used to support *state* policies. But many eminent tax authorities, including the late Randolph E. Paul, have felt that the primary purpose and function of taxation should be to raise revenue and not to compel conformity in non-Federal areas; they assert that, under our concept of federalism, each state should be the enforcer of its own regulations, unaided by Federal sanctions.

"The IRS and the Tax Court appear to have adopted a position closely allied to that espoused by Mr. Brownell. But the circuit courts, particularly the Seventh, have seriously questioned how far this policy should be extended. Although in the recent *Tank Truck Rentals* case the Supreme Court reiterated its acceptance of the 'frustration of public policy' test, it seemingly has rejected the extreme approach of Mr. Brownell, for in addition to the requirement of a clearly defined policy which it has laid down in the past, the Court advanced two additional factors which must be balanced in determining deductibility: (1) the degree to which public policy is frustrated in allowing the deduction and (2) the degree of hardship to the taxpayer in disallowing the deduction.

"The *Tank Truck Rentals* case, 356 U. S. 30 (1958) presents, in its broadest aspects, the problem of the deductibility of fines and penalties under the Federal income tax laws. Compelled by business necessity, in common with other operators, taxpayer risked the possibility of fines by regularly and *intentionally* carrying liquids on its trucks in excess of an exceptionally low Pennsylvania weight limit and, of course, whenever apprehended, taxpayer had to pay. In addition, it *inadvertently* incurred similar weight limit fines in neighboring states. The Commissioner, while conceding that the fines might be ordinary and necessary expenses of doing business, refused to allow their deduction on the ground that to do so would frustrate public policy. Both the Commissioner and the Tax Court determined that all the statutes involved were punitive in nature and that there was no valid distinction between culpably negligent or willful violations on the one hand and inadvertent ones on the other. On appeal, the decision was affirmed by the Third Circuit and the Supreme Court.

"In *Commissioner v. Sullivan*, 356 U. S. 27 (1958), decided the same day as *Tank Truck Rentals*, the Court held that expenses for rent and salaries incurred in the operation of a gambling house should be allowed, even though such payments were expressly made illegal under an Illinois statute, since the denial of such fundamental expenses would impose a tax on taxpayer's gross, rather than net income. Thus in *Sullivan* the Court determined that, although state policy was clearly defined, the degree of hardship in denying the deduction overbalanced the severity of the frustration of public policy, while in *Tank Truck Rentals* it felt that the frustration outweighed the hardship.

"Although it seems obvious that one

who bribes officials or pays gambling fines should not be permitted a deduction thereof, it would also appear that *Sullivan* and *Tank Truck Rentals* would not be inconsistent with some relaxation of the test of frustration of public policy when the statute involved is merely *remedial* in nature, or where the taxpayer's violation was *inadvertent*.

"Petitioner in the *Tank Truck Rentals* case sought to base his deduction upon the argument that the Pennsylvania statute was remedial and the deduction, therefore, properly taken under the rule of *Jerry Rossman Corporation* (175 F.2d 711 (2d Cir. 1949)). In the *Rossman* case Judge Learned Hand had observed: 'There are "penalties" and "penalties," . . . some are deductible and some are not.' He went on to distinguish between *punitive* fines and *remedial* fines, the former being imposed as a deterrent or punishment and the latter for the purpose of rectifying inequities in a given situation or to return matters to the status quo.

"The OPA statute involved in the *Rossman* case exemplifies both punitive and remedial aspects. The Administrator was to determine which aspect of the statute would be invoked; if the violation was determined to be willful or culpably negligent, the fine imposed would be punitive, while if the violation were purely inadvertent, the fine would be considered only remedial. Thus, since the *Rossman* taxpayer had only inadvertently overcharged its customers, had admitted its error promptly, and had paid all the excess receipts over to the Administrator, the court held that, although the payment was technically a fine, it was imposed for the violation of a merely remedial statute and was therefore deductible. Since the purpose of a remedial statute, by definition, is not to punish and since the fine was based on the remedial portion of the statute, the Second Circuit felt that the deduction clearly would not 'frustrate sharply defined policies' by mitigating the taxpayer's punishment.

"The Supreme Court in the *Tank Truck Rentals* case rejected the applicability of the *Rossman* doctrine on the grounds that the Pennsylvania statute was punitive and not remedial. While this characterization might be open to question, the Supreme Court and lower court opinions indicate that, if the statute had been found remedial, the taxpayer's deduction might have been allowed. This is sound because the violation of such a statute, even if the violator's conduct were characterized as culpably negligent or intentional, would not inordinately frustrate 'sharply defined policies.' Furthermore, to deny such a deduction would in many cases impose a hardship incommensurate with the public policy served by the denial of the deduction.

"While the rejection of *Rossman* as an applicable precedent was sound, the Supreme Court's refusal to consider inadvertency as a factor affecting deductibility unless the statute itself drew a distinction between intentional and unintentional violations is unfortunate.

"The majority of penal statutes in this country require mens rea—intent or 'equivalent' negligence—for conviction. Since the turn of the Twentieth Century, however, both the Federal Government and the states have passed a myriad of so-called 'public welfare' statutes requiring only the *doing* of the forbidden act to invoke the penalty provision. These statutes were enacted to protect the public from dangers existing in areas such as vehicular traffic and impure drugs, where the paramount need for protection coupled with the difficulty or impossibility of proving the necessary mens rea dictated the grouping together of the intentional, culpably negligent, and inadvertent violator alike, in order to provide a more adequate sanction. Here society has deemed it necessary to punish all violators. When the taxpayer seeks a deduction, however, the problem of proof would no longer require grouping all the violators together, since the burden would be upon the taxpayer to prove to the satisfaction of the Commissioner or the court that the violation was inadvertent. To allow the deduction of those fines which the taxpayer could show he had incurred in inadvertent violations of these 'pubic welfare' offenses clearly would not frustrate the public policy with such severity as to outweigh the hardship to the taxpayer from the denial of the deduction." ☆

AICPA requires recognition of taxes deferred by fast write-off

COMPANIES WHICH USE a rapid write-off method to compute depreciation charges for tax purposes, but not on their books, should provide currently for the taxes that will have to be paid when the benefits of accelerated depreciation have expired. A company using the two different methods would overstate its net income if it did not show as an expense a provision for the deferred taxes. This is the position taken in a new accounting research bulletin, No. 44 (Revised), issued recently by the American Institute of Certified Public Accountants. The bulletin reverses a position taken in 1954 that it was not necessary to give accounting recognition to these deferred taxes.

The committee on accounting procedure, in discussing the reasons for the change in position, pointed out that, "Following the passage of the Internal Revenue Act of 1954 permitting the use of declining-balance and similar accelerated depreciation methods for Federal income-tax purposes, the committee anticipated that many companies would be considering whether such methods should be adopted for general accounting purposes. In October of that year, Accounting Research Bulletin No. 44 was issued in which the committee stated that such accelerated methods met the requirement of being "systematic and rational." The committee also stated that, when such methods were adopted for general accounting purposes, appropriate disclosure of the changes should be made whenever depreciation was a significant factor in the determination of net income.

"Since the issuance of Accounting Research Bulletin No. 44, the committee has been observing and studying cases involving the application of the bulletin. Studies of published reports and other source material have indicated that, where material amounts are involved, recognition of deferred income taxes in the general accounts is needed to obtain an equitable matching of costs and revenues and to avoid income distortion, even in those cases in which the payment of taxes is deferred for a relatively long period. This conclusion is borne out by the committee's studies which indicate that, where accelerated depreciation methods are used for income-tax purposes only, most companies do give recognition to the resultant deferment of income taxes, or alternatively, recognize the loss of future deductibility

for income-tax purposes of the cost of fixed assets by an appropriate credit to an accumulated amortization or depreciation account applicable to such assets."

The committee therefore adopts the position that, when accelerated methods are used on tax returns but not for financial reporting, "accounting recognition should be given to deferred income taxes if the amounts thereof are material, except in those rare cases . . . where there are special circumstances which may make such procedure inappropriate. The foregoing provision as to accounting recognition of deferred income taxes applies to a single asset, or to a group of assets which are expected to be retired from service at about the same time; in this case an excess of depreciation taken for income-tax purposes during the earlier years would be followed by the opposite condition in later years, and there would be a tax deferment for a definite period. It applies also to a group of assets consisting of numerous units which may be of differing lengths of life and which are expected to be continually replaced; in this case an excess of depreciation taken for income-tax purposes during the earlier years would be followed in later years by substantial equality between the annual depreciation for income-tax purposes and that for accounting purposes, and a tax deferment would be built up during the earlier years which would tend to remain relatively constant thereafter. It applies further to a gradually expanding plant; in this case an excess of depreciation taken for income-tax purposes may exist each year during the period of expansion in which event there would be a tax deferment which might increase as long as the period of expansion continued.

"Where it may reasonably be presumed that the accumulative difference between taxable income and financial income will continue for a long or indefinite period, it is alternatively appropriate, instead of crediting a deferred tax account, to recognize the related tax effect as additional amortization or depreciation applicable to such assets in recognition of the loss of future deductibility for income-tax purposes."

By using a fast write-off method on the tax return and a slower method on the books, a company would overstate its net income if it did not show, as an expense, a provision for the taxes thus deferred. ☆

IRS seeks to defer gain on note until sold

THE COMMISSIONER has reversed his usual position that any salable instrument having a determinable market value is includible in the income of a cash-basis seller at the time of receipt. In a case now before the Tax Court (*Dutoit,* Docket No. 73061) he is seeking to tax the gain on a promissory note at the time of its sale to a third party four years after its receipt by taxpayer.

Mr. Dutoit, a cash-basis taxpayer, sold his house in 1949 for $6,500. The purchaser paid $1,200 in cash and gave his promissory note for the balance. Believing that gain on the sale of a personal residence was not taxable, Mr. Dutoit did not include the transaction in his 1949 return. In 1953 he sold the note and again took the position that the transaction was non-taxable. He claimed that the gain on the sale of the house was taxable in 1949 and that the tax basis of the note was equal to its face value at the date of sale.

The Commissioner is taking the position that no gain was realized in 1949 when the note was received. The transaction was not closed until the note was sold in 1953, at which time a taxable gain was realized.

The trend of the courts in cases involving cash-basis taxpayers has been to make the time of taxability hinge upon the negotiability of the instrument. Negotiable instruments have been held to be the equivalent of cash and so taxable at the time of receipt; whereas non-negotiable instruments have not been construed as producing income until collected. In this case, the pleadings do not indicate the negotiable status of the note at issue, possibly because the Commissioner has not tended to take the point into account. His position has always been that a cash-basis seller had income at the time of receipt if the instrument was salable and its value could be determined. He now takes a stand diametrically opposed to this, in an apparent attempt to tax the transaction at some point, and it will be interesting to see whether the decision of the court turns upon the issue of negotiability. ☆

New accounting decisions this month

Note received in liquidation valued at face amount. Upon liquidation of a corporation, taxpayer received a $7,000 face value note, payable over some eight and one-half years, in quarterly installments totaling $8,500 (representing a premium of $1,500 on the principal amount). Based on the facts as they were at the time of the liquidation, and as corroborated by the payments thereafter made, the court holds that there is no justification for taxpayer's reporting the receipt of the note at less than its principal amount. *Castner Co., Inc.,* 30 TC No. 112.

Elaborate capital gains deal held "without substance"; no deductions. In 1952 taxpayer purchased $10 million of Treasury notes, using borrowed money in a transaction of a type much discussed at that time whereby U. S. bonds, selling at a discount, were purchased because the full payment at maturity would result in capital gain and the payment of interest would, it was thought, be deductible. The particular transaction here is found by the court to be without substance. There was no borrowing, no indebtedness and no real payment of interest. The creditor, a wholly owned corporation of the broker who arranged the transaction, did not have the funds to make the loan of almost $10 million; in fact, it sold the notes the same day. If taxpayer did not know this, he did know that he had authorized the lender to do it. The payments of interest were in reality a mere exchange of checks with the lender. Of course, the purported collection of interest income must be ignored also. Finally the $15,000 paid by the taxpayer as down payment on the bonds is held to be in reality a fee to the broker, but not deductible because only expenses in connection with real transactions for profit are allowable. An unpublished ruling issued to the broker was not, the court notes, concerned with taxpayer at all, though the transaction described in it was similar to taxpayer's. And, the court adds, that ruling presupposed real interest and real payment. *Goodstein,* 30 TC 124.

Gain on redemption of discount bonds a capital gain (Old Law). In 1950 taxpayer acquired (whether or not from the issuer is not stated) debentures in the face amount of $74,000 payable in fixed amounts to 1954. His cost was $60,000.

The bonds were redeemed for $74,000 prior to maturity in 1952 when the principal amount due under the original payment schedule was $71,400. Taxpayer conceded that $2,600 ($74,000-$71,400) was ordinary income, but claimed capital gain treatment of the rest of the profit. The Commissioner argued that *Caulkins* (1 TC 656, *aff'd.* 114 F.2d 482) was incorrect in allowing such a result. The court sees no reason to depart from that rule for cases covered by the 1939 Code. [The 1954 Code required ordinary income treatment of part of the redemption proceeds of bonds issued at a discount by prorating the discount over the life of the bonds and treating the portion applicable to the period the taxpayer held the bonds as ordinary interest; the 1958 Technical Amendments Act allows proration only if the discount bonds were not issued with the intention to redeem before maturity. If there was this intent, the entire discount is ordinary income.—*Ed.*] *Goodstein,* 30 TC No. 124.

Gain on real estate purchased at tax sales capital. Over a three-year period taxpayers sold 185 lots which they purchased at tax sales. A jury finds that taxpayers did not hold these properties for sale in the ordinary course of business. The gain on their sale is, therefore, capital. *Emery,* DC *Fla.,* 7/9/58.

Investment cotton stored by farmer is capital asset. Taxpayers were partners in the operation of a cotton farm. Each year they stored some cotton of a certain grade separately from the regular crop. The court finds this stored cotton was held for investment purposes and not for sale in the ordinary course of business. Accordingly, the gain was capital gain. [The opinion does not disclose whether the stored cotton was ultimately sold in one or two transactions or in small lots.—*Ed.*] *Stefka,* DC Tex., 8/16/58.

IRS will concede patent sale despite payment on use [*Acquiescence*]. In 1946 the Tax Court held, *Myers* 6 TC 258, that a patent was sold and the proceeds should be treated as capital gain even though the selling price was based on production or use. The Commissioner non-acquiesced, but Congress adopted the Tax Court position in the 1954 Code and in 1956 applied the rule retroactively to 1950. However, in situations not specifically covered by the Code, the IRS maintained its position. It now announces (TIR-810) that it will no longer take the position, in litigation or administratively, that the mere retention of an interest resembling a royalty by the assignor or transferor of a patent in a transaction which otherwise has the characteristics of a sale in and of itself prevents capital gain treatment. *Rev. Rul.* 58-353. It announces acquiescence in the following cases: *Coplan,* 28 TC No. 141, *acq.,* IRB 1958-29; *Champayne,* 26 TC 634, *acq.,* IRB 1958-29; *Golconda,* 29 TC No. 57, *acq.,* IRB 1958-29; *Myers,* 6 TC 258, *previous non-acq. withdrawn, acq.* IRB 1958-29; *Philbrick,* 27 TC No. 36, *acq.,* IRB 1958-29; *Ruge,* 26 TC No. 14, *acq.,* IRB 1958-29; *Speicher,* 28 TC No. 104, *acq.,* IRB 1958-29.

Over-ceiling payments not deductible as loss. Taxpayers' partnership paid $14,000 in over-ceiling payments on 500 cases of whiskey. In fact, it received delivery on only 50 cases. The Commissioner had allowed 10% of the payment as applicable to the 50 cases actually received and sold. The court approves his failure to allow the balance. There is no basis for including the payment as part of cost of goods sold since the goods were never received. Nor can taxpayers claim a loss deduction. While a loss has been incurred, taxpayers have failed to prove the year in which it was sustained. The court thus finds it unnecessary to consider whether the payment should be disallowed on public policy. *Spenger,* DC Calif., 7/10/58.

Mortgage broker not real estate dealer; gets capital gain. Taxpayer's principal occupation was that of mortgage broker, although he also held a real estate dealer's license. In the tax year he sold four tracts of land he held individually and one tract held by a partnership in which he was interested. The sale by the partnership was to a corporation in which the partners retained a 45% interest; the corporation planned to subdivide. The individually-owned tracts were sold without any selling effort on taxpayer's part. In each case the purchaser had initiated the transaction. The court concludes the tracts were all held for investment, resulting in capital gain. *Carruth,* DC Tex., 7/28/58.

Payments for equipment are depreciable costs, not rent. A construction contractor made periodic payments under conditional-sales agreements covering various items of construction equipment used in his business. He sought to deduct the payments as "rentals," but the court finds they constitute capital expenditures and approves the Commissioner's determination respecting allowances for depreciation on the equipment and the taxation of gain on their disposition. *Irby,* 30 TC No. 123.

Dealer has ordinary income on real estate sales. Taxpayer was in the real estate business, but he claimed that certain parcels were investment property. The court holds that they were held for sale in the ordinary course of business. It states the tests as follows: (1) taxpayer's occupation; (2) frequency of the sales; (3) length of time the property was held; (4) extent of taxpayer's sales efforts; (5) time devoted to this as compared with other undertakings; (6) amount of sales income compared with other income. Each of these tests points to the sales' being part of taxpayer's business. Furthermore, taxpayer testified that he purchased these properties to increase his holdings of mortgage notes, which implies he bought them for resale on credit. *Durr,* DC La., 6/18/58.

Ordinary loss on stock bought to protect franchise. Taxpayer, a department store, was forced to purchase the stock of a manufacturer of women's suits (Handmacher) in order to keep its exclusive territorial franchise. Shortly thereafter taxpayer started to look for an alternative supplier and three years later dropped the old franchise and sold the stock. The loss was 80%. The court allows the taxpayer to deduct it as business expense. The only evidence that would tend to show that taxpayer regarded the stock as an investment, rather than a business expense, was that it was entered on taxpayer's books in an investment account. This is not conclusive, especially as the books were prepared by independent accountants. The court rejects the Commissioner's argument that, since the stock falls within the definition of a capital asset, the loss must be a capital loss, citing *Corn Products Refining,* 350 U.S. 46, in which the Supreme Court denied capital gains treatment to hedging contracts which concededly were "capital" assets because the gains arose in the normal course of business. *Smith & Welton, Inc.,* DC Va., 8/8/58.

Expensing of water lines permitted. A jury answering special interrogatories

finds that transfers of real estate by individuals to corporations were intended to be contributions to the corporation's capital rather than to create a debtor-creditor relationship. The jury further found that the cost of constructing water and sewage plants and lines was ordinary and necessary and did not increase the value of the land *West,* DC Tex., 7/30/58.

ACCOUNTING METHODS

Contractor was on cash basis; can deduct payments only. A contractor whose records, the court said, were not books of account which reflected any particular method of accounting is found to have used the cash method in preparing his 1952 and 1953 returns. The court holds items of expense incurred in 1953 pertaining to jobs performed in that year are deductible only in the year 1954, when actually paid. *Irby,* 30 TC No. 123.

Liability for uncontested sales taxes accrues in year of sale. Taxpayer deducted the expense for delinquent 1948 and 1949 sales taxes in 1951 when it paid the tax. The court finds that, since it did not contest the tax liability, taxpayer on the accrual basis must take the deduction when it accrued in the earlier years. Section 1311, mitigating the effect of the statute of limitations, is applicable to effect the adjustment. *Wilson-Weesner-Wilkinson Co.,* DC Tenn., 8/4/58.

Approve method of reporting unsold crop as income. Since 1922 taxpayers, partners in a cotton farm, had consistently followed the accounting method of taking into income the fair market value of their unsold cotton crop at the year end. They had always consulted IRS personnel for assistance in preparing their returns. The Commissioner now attempts to tax the full proceeds in the year of sale. However, the court upholds taxpayers' reporting method. The income had been taxed in the earlier year in which the crop was raised. The basis of the crop is the amount thus taxed as income. *Stefka,* DC Tex., 8/16/58.

Auto dealer has income when finance company credits his reserve. Net increases in loss reserve accounts withheld by financial companies from an accrual basis auto dealer as security in purchasing automobile notes and contracts are held taxable to the dealer in the years credited. The court notes the split in circuits on this problem with the 4th, 5th and 8th circuits holding against the Commissioner, while this circuit and the 7th hold for him. *Schaefer,* CA-6, 8/20/58.

Commissioner admits error in changing consistent inventory method. For at least 15 years prior to 1953 taxpayer followed a consistent method of inventory valuation. The Commissioner admitted error in his determination that the closing inventory for 1953 should be changed and moved for judgment in favor of taxpayer on the pleadings. The court finds the correct value of the closing inventory to be that shown on taxpayer's original return. *Milwaukee Valve Co.,* TCM 1958-164.

Accrual basis taxpayer can't defer profit on non-qualifying installment sale. Taxpayer, a corporation on the accrual basis, sold its machinery and equipment for $11,000, receiving $3,000 in cash and an $8,000 10-year note payable in quarterly installments. Since the initial payments received during the taxable year exceeded 30% of the selling price, the corporation could not use the installment basis. The court also points out that, inasmuch as the corporation was on the accrual basis, it could not use the deferred payment method of reporting allowed by the Regulations to cash basis taxpayers. Moreover, that method is used only if the note is not worth face value, and taxpayer did not show that. Taxpayer must report the full face value of the note as an accrued receivable from the date of sale, and it is to be taken into account in determining the taxable profit. *Castner Co., Inc.,* 30 TC No. 112.

OTHER DECISIONS

Court finds payments were for agreement not to compete. Taxpayers purchased the interest of a former partner for $70,000, some $37,000 in excess of its book value. The partnership was in the lumber, hardware and wrecking business. They are allowed to amortize the $37,000 over a five-year period upon proof that such sum was paid for the seller's oral agreement not to compete for five years, and that such agreement was in fact carried out. Taxpayer testified that the buyer wanted only an oral agreement not to compete and he did not realize until after he changed accountants that there was any tax benefit involved. *St'd. Lumber and Hdwe. Co.,* TCM 1958-159.

Salvage value determined at date of changeover to straight-line method. In changing from the declining-balance method of computing depreciation to the straight-line method, salvage value is to be determined in accordance with the conditions existing at the time of the change, and not at the date of acquisition. *Rev. Rul.* 58-420.

Cash from controlled corporations income to stockholder. Some 400 checks were issued to taxpayer, or to cash, by several corporations controlled by taxpayer. The court finds that they were unreported income. Taxpayer had contended that the checks were issued to him in reimbursement of loans and advances. *Weir,* TCM 1958-158.

Exemplary damages includible in income. Amounts received in settlements of a libel suit covering both compensatory and exemplary damages are taxable income only to the extent of the exemplary damages. Expenses attributable to that portion of the award are deductible as ordinary and necessary expenses for the production or collection of income. *Rev. Rul.* 58-418.

No income to stockholder-lessor when corporation erects buildings on her land. Taxpayer was a principal stockholder and chief financial backer of a machinery manufacturing company which had used some land adjacent to its buildings. She bought that land from third parties for $8,000 and in 1946 leased it to the corporation for six years. The corporation erected buildings at a cost of $21,000. Under the lease, the buildings would revert to her at the end of six years and the corporation would pay taxes and maintenance, but no other "rent." The Commissioner computed the value as of 1946 of the reversion of the buildings after six years as about $15,000 and treated it as income to her. In the alternative, he also claimed that the value of the buildings in 1952 ($18,000) was income then. The Tax Court held that she realized income in neither year because the parties never intended the reversion of the buildings to be rent. The Tax Court reviewed cases on lessor's income from lease improvements and concluded that, under the Code, the

improvements are income only if the parties intend them to be rent. It accepted the taxpayer's testimony that the buildings would be useful to no other company and that she would have required their removal had she been dealing with a stranger. This court affirms the Tax Court holding that, under these circumstances, there was no intent to pay rent in the form of improvements. [The Commissioner has non-acquiesced in the decision of the Tax Court. IRB 1958-17.—*Ed.*] *Cunningham,* CA-9, 7/29/58.

No business bad debt for advances by stockholders. Taxpayers sought to deduct as business bad debts the worthlessness of loans they had made to a corporation in which they were stockholders by arguing that they were carrying on their cigar sales promotion business through the medium of the corporation. The court denies a business bad debt deduction, pointing out that the losses bore no proximate relation to any business carried on by taxpayers since the business of a corporation is not considered to be the business of its stockholders. *Mays,* TCM 1958-156.

Guaranty loss a non-business bad debt. A loss suffered by taxpayer from the payment of his liability to a bank as guarantor of corporate obligations is a non-business bad debt. The evidence showed that the loss arose out of taxpayer's unsuccessful attempt to salvage a portion of his investment in the corporations, not out of any activity which could be related to his claimed business as a promoter. *Weir,* TCM 1958-158.

Indefinite rights to income must be valued. The Service will continue to require valuation of contracts or claims to receive indefinite amounts of income, such as those acquired in liquidation of a corporation, in spite of the difficulties of valuation. Only in rare and extraordinary cases will such property be considered as having no ascertainable value. *Rev. Rul.* 58-402.

Judgment not income in year collected. In 1952 taxpayer, on the cash basis, collected a judgment which represented his share of the profits for 1949 of a joint venture of which he was a member. Without discussion, the court decides the proceeds of the judgment did not constitute income in 1952, the only tax year at issue. The attorney's fees paid by taxpayer were contingent and could not be ascertained until the litigation was completed. They are allowable as 1952 deductions. *Donnelly,* DC Okla., 8/5/58.

Commissioner loses another finance company dealer's reserve case. The Seventh Circuit seems to be alone in its position (shown by the recent *Baird* case) that finance company dealer's reserves are income. The Ninth Circuit here agrees with the other circuits that an accrual basis auto dealer need not include in his income that part of the sales price of cars sold that the finance company keeps in a reserve account as protection against defaults. The court rejects the Commissioner's argument that the sale of the cars and the sale of the notes to the finance company are separate transactions as not being a realistic view of the transaction. *Hansen,* CA-9, 8/4/58.

No basis for loss on transfer of assets for stock. Taxpayer is denied a deduction for an alleged loss resulting from a transfer of assets in a laundry business to a corporation in exchange for stock, an employment contract and an option to recover the assets if the corporation failed to obtain a certain Air Force contract. Upon the record there was no foundation for a determination that the fair market value of what was received was in fact less than the adjusted basis of the assets transferred. *McKim,* TCM 1958-154.

Sale by corporation was for stockholder; he has gain on it. Taxpayer's corporation was indebted to him. He caused the corporation to transfer a building to a bank, which sold the property and applied the proceeds in discharge of taxpayer's personal liability to the bank as a guarantor. The court holds taxpayer suffered no loss from the cancellation of the corporate indebtedness since the corporation transferred the building to the bank, as taxpayer's nominee, in consideration for the cancellation. On the contrary, taxpayer realized a short term capital gain from the sale of the property. *Weir,* TCM 1958-158.

Surviving joint tenant has no change in basis (Old Law). Taxpayer and her deceased husband owned property as joint tenants. Following her husband's death in 1946, she claimed fair market value at his death as depreciation basis for one half of the property, on the theory that she acquired it by inheritance. The court holds that she must continue to depreciate it on the basis of original cost. This is not inherited property. Taxpayer, as a surviving joint tenant, did not acquire, upon the death of the other joint tenant, any rights not previously owned by her. [Upon the death of a joint tenant after 1953, the survivor's basis is estate-tax valuation.—*Ed.*] *Gits,* DC Ill., 7/17/58.

Loss carryover must be corrected for renegotiation and amortization, but not for EPT changes. At issue here is the computation of the 1944 income in figuring the amount of loss carryback from 1946. Taxpayer's 1944 income as originally reported was reduced by subsequent renegotiation of profits and recomputation of accelerated amortization when the original 60-month period was shortened at the end of the war. Due to these changes, the original 1944 excess profits tax was refunded in part. The court holds that the *Lewyt* case (349 U. S. 237) requires that the 1944 excess profits tax as accrued at the end of 1944 is the tax to be deducted (the Code allows the deduction of EPT in computing net income to which the carried over loss is applied). However, renegotiated profits repaid and additional accelerated amortization should be deducted as finally determined. The Commissioner argued that the different treatment of these items is illogical, but the court holds itself bound. Nor will it consider the argument that the EPT refund was in effect a tax benefit that should be considered in this computation. That argument was rejected in *Budd,* (252 F.2d 456). *Jacobs Co.,* 30 TC No. 125.

Trust property involuntarily converted; beneficiaries can qualify for relief. Property owned by a trustee was involuntarily converted, and shortly thereafter the trust terminated and the trust res was distributed. The beneficiaries, it is held, may take advantage of the non-recognition provisions of Section 1033 by investing in property similar or related in service or use to the property held by the trustee. This case is essentially similar to *Goodman* (199 F.2d 895), in which an executor was allowed the benefits of the section upon investment of the funds though condemnation occurred prior to decedent's death. Here, too, the trustee was acting as the beneficiary's representative. *Rev. Rul.,* 58-407.

THE TAXATION OF INDIVIDUALS

Personal tax problems

IRS denying educational expense that would be ordinary and necessary for business

by **H. HELMUT LORING**

Despite the IRS' more liberal position in its final Regulations than in the proposed, the professional man, particularly the self-employed, is still being subjected to more stringent rules on his educational costs than a businessman spending money for possible future return. Mr. Loring analyses the final Regulations in the light of litigated cases and concludes that persons whose situations are not specifically covered by the Regulations still have to meet unduly restrictive tests.

ON APRIL 4, 1958, the Treasury issued in final form Regulation Section 1.162-5 governing the deductibility of educational expenses.[1] The Regulations as adopted differ substantially from the Regulations in their proposed form which had been published by the Treasury on July 10, 1956 and the changes reflected in the final Regulations have been hailed by many observers as a substantial liberalization of the Treasury's position in favor of a group of deserving taxpayers.

This article examines the nature of some of these changes to determine whether there is a sound basis for such expressions of optimism.

The problems of schoolteachers

It has been established for some time that schoolteachers may deduct all educational expenses necessarily incurred in order to maintain their teaching credentials in accord with applicable requirements of state law, whether such requirements consist of attendance at universities, travel, or a choice of these and other educational experiences.[2]

But even in the proposed Regulations on this subject the Treasury still took pains to make it clear that, if the attendance at summer school or other such educational activity would result in a substantial salary increase, the deduction for the expense would be denied.[3]

Likewise, the proposed Regulations seemed to perpetuate the Treasury's view that voluntary intellectual curiosity should be discouraged. Accordingly, the deduction for educational expenses was denied unless state law or the employment contract made the educational experience, for the expense of which the deduction was claimed, a condition for the retention of the taxpayer's teaching job.

That these requirements for deductibility were unsound in law as well as unwise in policy has been argued by this writer in an earlier article.[4]

The regulations in their final form indicate clearly that the Treasury has retreated from its earlier position.[5] Thus, the schoolteacher who voluntarily takes special courses in his field to improve his skill will be allowed the deduction, even where the taking of such courses results in "an ingrade increase in salary in his present position pursuant to a salary schedule established by the school system for which he works."[6] Likewise, a teacher who must attend summer school sessions to retain his position will not be deprived of the deduction merely because such courses, taken over a period of years, will gain him an advanced degree and thus qualify him for a higher paid teaching position.[7] However, a schoolteacher who voluntarily takes a year's leave of absence from his job to study for an advanced degree qualifying him for a salary increase will undoubtedly find the Commissioner unmoved by this display of eagerness to acquire knowledge.[8]

Whether such a limitation is justified is another question. The businessman who expends funds on promotion can deduct his expense though the sole purpose of incurring the expenditure is to increase his sales.[9] It would appear that, if the normal rules of deductibility were applied, advancements in salary by reason of the educational expenditure would not bar deductibility unless the education was designed to qualify the taxpayer for an entirely different job, in which case the expense would be in the nature of a non-amortizable capital expenditure.

Finally, it should be noted that only the expenses for travel, meals and lodging "while away from home overnight in pursuit of educational activities" — provided they are deductible under the rules just outlined — may be deducted by teachers and other employees in computing adjusted gross income. The deduction for all other expenses is lost if the taxpayer uses the standard deduction.[10]

Both proposed and final regulations reflect prior case law[11] that professional persons can deduct the expenses of attending courses of a "refresher" kind, such as e.g., the courses offered by university extension divisions, by bar associations and by other educational institutions for the continuing education of the bar, or the various annual tax seminars offered by many universities throughout the country.[12]

The professional man

Two problems will probably appear in this area. One arises by reason of the fact that many busy professional people combine the attendance at the course with their vacation. The Regulations make it clear that, so long as the primary motive is the attendance at the course, additional recreational activities will not endanger the deductibility of the expense incurred, except for the expenditure directly related to the extracurricular activity, which is, of course, personal.[13] By the same token, where the personal activity is the primary motive for taking the trip, all expenses of the trip except those directly related to the attendance of the course are personal, and hence not deductible.[14]

More difficult may be the question of when courses attended are truly of the "refresher" type, i.e., intended to keep taxpayer proficient and up-to-date in his chosen profession, as distinguished from courses designed to prepare the taxpayer either for a new and different

profession or for a specialty within the profession already practiced. The examples given in the Regulations merely refer to the obvious situations, as where a general medical practitioner undertakes studies to qualify as a specialist in one of the recognized specialty fields of medicine.

Let us assume the case of a lawyer who, after obtaining his law degree, practices for some time, specializing in taxation. After some years, confounded by the intricacies of our tax laws, he takes a leave of absence for one year, attends a university especially equipped in the tax field, and obtains an LL.M. degree or JSD degree in taxation and then returns to his prior practice.

While the Canons of Professional and Judicial Ethics of the American Bar Association recognize the existence of fields of specialty,[15] only the practice of patent, trademark and copyright law has been expressly designated a specialty to date.[16] Even if it is probably true that lawyers exclusively engaged in a tax practice are specialists, the problem remains because, unlike the field of medicine, no special additional formal training or degree is required to specialize in any particular field of law.

Our example demonstrates some shortcomings of the new Regulations which, while undoubtedly a liberalizing of the Treasury's prior position in many respects, have not seen fit to return to those basic tests which govern the applicability of Section 162 of the Code, namely, whether an expenditure is "necessary," rather than personal, and "ordinary," rather than a capital outlay. While the facts outlined here would seem to meet the tests of the Regulations for deductibility, the deduction may well be improper because the expenditure is not "ordinary," if one looks to the experience of tax lawyers as a group.[17] Of course, this would be a question of fact and the answer may change as such extended courses become an accepted and customary method of keeping abreast of developments in fields of specialty without becoming a requirement for entry into such specialty field.

It would seem clear that a person who obtains the advanced degree immediately after completing his basic training in his profession would be denied the deduction for the expense of the additional training, not because the expense is personal, as the Regulations would have it,[18] but because the expense is in the nature of a non-amortizable capital outlay. But let us add to the facts of our earlier example the additional condition that our tax lawyer has been an employee of a law firm, and his employer requires him to take the course as a condition for retaining his employment. The new Regulations make the expense of the advanced course deductible[19] because incurred to meet the express requirements of taxpayer's employer for the retention of taxpayer's present position. While the nature of the expenditure has not actually changed (i.e. its character as "ordinary" or "capital"), the added fact has made the expense deductible.

A recent court decision has given substantial significance to this test. In *Marlor*,[20] the taxpayer was appointed tutor at a New York College, subject to the regulations of the New York Board of Higher Education. It was there provided that taxpayer could retain his employment only by diligently working toward his Ph.D. degree and by obtaining the degree within a specified period of time. Reversing the Tax Court, and adopting the opinion of the three dissenting Tax Court judges below, the Second Circuit held that the expenses incurred in working toward and obtaining the Ph.D. degree were deductible. Under the rule of this case, an expenditure which would normally be classified as a capital outlay and thus not deductible would seem to be converted into a currently deductible expense if required for the retention by the taxpayer of his current position, no matter how temporary, and despite the obvious fact that taxpayer is just embarking upon his career, and not yet established therein. In other words, the expenditure becomes "ordinary" because it is "necessary" in a high degree.

This is a novel rule of tax law not applied in other situations[21] and the Treasury has indicated in the Regulations that it does not approve of this rule.[22]

Even if the holding of *Marlor* under the facts of that case is not considered sound legal reasoning, it is merely the application of the test which the Treasury for years urged as practically the exclusive criterion, namely, whether the expenditure was required by state law or regulation. Some may think that this case applies this rule ad absurdum, but it may help the Treasury to return to those sound and simple basic concepts of "ordinary" and "necessary" which have governed the application of Section 162 of the 1954 Code and the like provisions in prior revenue acts. If those tests had been applied, the court would probably have reached the conclusion that Mr. Marlor had hardly embarked upon his career, and that the expense for the Ph.D. degree was a condition precedent to his academic career generally, and thus a non-deductible capital outlay.[23]

The university professor

That *Marlor* may turn out to be a Pyrrhic victory for the taxpayers may be demonstrated in the future when persons already well established in an academic career seek to deduct various educational and research expenses. There is no clear indication in the new Regulations that the Treasury has re-

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[1] It should be noted that the new regulations are applicable to all years from January 1, 1954. See TIR No. 76, April 11, 1958. Note that the Technical Amendments Act lifts the statute of limitations for filing claims under this regulation for years beginning after 12/31/53 and ending after 8/16/54. Claim may be filed, in most cases, within 60 days after enactment, which was September 2, 1958.
[2] Hill, 181 F.2d 906 (4th Cir. 1950); Fennell Tax Ct. Mem. 489 (Dkt. 42,403) (1953); Cf. Thompson, Tax Ct. Memo 1957-62 (1957).
[3] See Proposed Reg. Sec. 1.162-5(g) Example (3).
[4] See Loring, Some Tax Problems of Students and Scholars, 45 Cal. L. Rev. 153 (1957); 7 JTAX 248.
[5] See Reg. Sec. 1.162-5(e) Examples (3), (4), (5) and (6).
[6] See *Ibid.* Example (6).
[7] See *Ibid.* Example (3).
[8] But see TIR No. 76, April 11, 1958, Example 11, which seems to establish as a test the primary motive or intent to improve the skills used in taxpayer's present position as against the intent to advance in position.
[9] See San. Farms Dairy, Inc., 25 TC 463 (1955).
[10] See TIR No. 83, June 30, 1958; Thompson, Tax Ct. Memo 1957-62 (1957).
[11] Coughlin, 203 F.2d 307 (2nd Cir. 1953); Bistline, 145 F. Supp. 802 (D. Idaho, 1956).
[12] Proposed Regulations Sec. 1.162-5(c) and (g) Example (2); Final Reg. Sec. 1.162-5(e) Example (2).
[13] *Ibid.* Example (8).
[14] *Ibid.* Example (9).
[15] See Canons 45 and 46.
[16] See opinion 203, ABA Committee on Professional Ethics and Guidance.
[17] See Welch v. Helvering, 290 U.S. 111, 114 (1933); DuPont, 308 U.S. 488, 495 (1940).
[18] Regulation Sec. 1.162-5(b).
[19] Reg. 1.162-5(a)(2).
[20] 251 F.2d 615 (2d Cir. 1958), reversing *per curiam* 27 TC 624 (1956).
[21] See e.g. Hotel Sulgrave, Inc., 21 TC 619 (1954) where a hotel was denied a current deduction and was required to capitalize the cost of installing a sprinkler system on the order of the city building department.
[22] Reg. 1.162-5(e) Example 7, though the facts of the example do not match the *Marlor* facts in all particulars.
[23] As pointed out earlier, the Regulations, Sec. 1.162-5(b) still classify educational expenses incurred in order to qualify for a career as "personal" rather than "capital."
[24] 17 TC 3 (1951).
[25] 30 TC No. 115 (1958). (It should be noted, however, that the years involved in that case were 1952 and 1953, thus not subject to the new regulations.)
[26] 16 Tax Ct. Memo. 1081 (1957).

treated from the Tax Court ruling in *Cardozo*,[24] which held expenses of a research trip by a university professor to be personal, and hence non-deductible, since not required in order to retain taxpayer's position.

Of course, the fact that the new Regulations allow deductions for voluntary educational activities of teachers may well have raised some hopes, but if such was the case, the recent decision in *Brooks*[25] has been quick to dispel them. In that case, viewing the facts as sympathetically as the Tax Court should have under the circumstances, taxpayer, a recognized scientist in her field, was employed by a university as a research associate at a salary of $500 per year. During the two years in question, she incurred expenses well in excess of her salary in connection with trips to Europe, whose bona fide research purpose was not in dispute. But despite the recent holding in *Vanderbilt*,[26] the Tax Court found that, inasmuch as taxpayer had never, prior to 1952, derived salary or other income from her research activities, she was not engaged in a trade or business. This finding is incongruous since during the years involved in the case the taxpayer was employed, for however low a stipend, as a research associate. For good measure, and to overcome the obvious weakness of this finding, the court went on to point out that there was nothing in the conditions of her employment which required her to undertake the research trips. This, of course, falls back upon the old and completely fallacious reasoning of the *Cardozo* case that research expenses, to be deductible, must be incurred for something which is a legal requirement for the maintenance of the taxpayer's position. Such is not the law under the "ordinary" and "necessary" test as applied in other factual situations. Taxpayer in the *Brooks* case was employed to do research in her special field; her research necessitated travel to Europe. The expenses should have been ruled deductible.

After the step forward in the field of education below the university level, as evidenced by the new regulations, a reappraisal of the Treasury's position on problems of the *Cardozo* and *Brooks* type in the light of a deeper appreciation of the realities of academic life seems urgently called for. One would have hoped that the high resolve of the post-Sputnik era to regard continuing study, education and research as highly desirable had reached all the way to the heart of the tax collector. But the mere fact that the *Brooks* case ever reached the Tax Court would indicate otherwise. ☆

Employee need not report travel to 12.5c a mile, subsistence to $15 a day

WHEN THE REGULATIONS on tax-reporting for expense accounts were issued this spring, the Commissioner promised to study the question of how employees should report mileage allowances and per diems for subsistence. The principle laid down in the Regulations is that an employee need not report on his tax return expenses for which he is reimbursed or for which he accounts to his employer. Now the IRS rules (Rev. Rul. 58-453) that an employee will be considered to have accounted to his employer for mileage allowances up to 12.5c per mile and for subsistence allowances up to $15 a day. Allowance in excess of these amounts must be reported by the employee as income, and expenses may be claimed.

The IRS explained that it determined the 12.5c and $15 limits after an extensive study of the "rates of mileage allowances and per diem allowances in lieu of subsistence paid . . . by a substantial number of employers, including states and municipalities, and the method of accounting for these allowances required . . . by such employers. On the basis of this study, it has been administratively determined that, for purposes of Section 1.162-17(b) of the Income Tax Regulations, an employee who pays or incurs ordinary and necessary business expense for travel (including meals and lodging) and transportation for which he is paid by his employer a fixed mileage allowance or a per diem allowance in lieu of subsistence at rates not in excess of 125% of the rates authorized to be paid by the Federal Government in the locality in which the travel is performed will be deemed to have been required to account to his employer for such expenses for purposes of such regulations.

"The maximum mileage allowance on a fixed scale authorized to be paid by the Federal Government for use of a personal automobile on official travel is 10c per mile, and the maximum per diem allowance on a fixed scale in lieu of subsistence authorized to be paid while traveling within the continental United States is $12 per day."

Foreign and unusual travel

The ruling points out that "the maximum per diem allowance in lieu of subsistence authorized to be paid by the Federal Government while traveling outside the continental United States varies depending upon the locality. For purposes of computing the maximum rates of per diem allowance in lieu of subsistence paid an employee by his employer for which the employee will be deemed to have been required to account to his employer, see Standardized Government Travel Regulations, Appendix I, Revised—Maximum Per Diem Rates in Lieu of Subsistence for Travelers Beyond the Limits of the Continental United States, incorporated in this ruling by reference thereto.

"If per diem allowances and mileage allowances paid by a particular employer do not fall within the scope of this *Rev. Rul.*," the ruling continued, "the presence of unusual circumstances which account for the variation may, nevertheless, constitute grounds for considering the employees of such an employer to be treated as though they accounted to the employer for their business expenses.

In such a case the employer should direct a request to the Commissioner of Internal Revenue, Attention: Tax Rulings Division, Washington 25, D. C., setting forth in detail an explanation of the arrangements under which these particular allowances are paid and the reasons for his belief that his special circumstances justify the same treatment as that accorded allowances falling within the scope of this ruling. The burden will be upon the employer in all such cases to establish to the satisfaction of the Commissioner the reasonableness of the allowances paid under the special circumstances involved. It should be understood that the payment of per diem allowances and mileage allowances by an employer in amounts greater than those specified herein will not, in and of itself, constitute an unusual circumstance and, therefore, requests based solely on such circumstance will not be approved." ☆

IRS states policy on construction workers' expense

PENDING THE DECISION of the Supreme Court in *Peurifoy*, (254 F.2d 483, *cert. granted* 5/19/58), the IRS has announced that claims for deductions for meals and lodging and travel expense away from home by construction workers will be decided in accordance with the Commissioner's letter of May 4, 1956, to Rep. Robert H. Mollohan.

In this letter, the Commissioner, while emphasizing that these cases usually turned on questions of fact, distinguished between "temporary" and "indefinite" employment. A temporary job is one the end of which can be foreseen in a fixed, short time. Employment lasting or expected to last a year or more would be considered indefinite. A place of indefinite employment is the taxpayer's home for tax purposes; a taxpayer temporarily employed is away from home if he can show a tax home elsewhere.

The Commissioner defined "tax home" as the place the employee usually works or from which he makes his business contacts, adding that the location of his residence and the fact that he returned to this locality at the end of every job would be significant. He then added that a construction worker should be able to establish a tax home if he follows his trade, is not regularly employed either for an indefinite period or at any single place, is not an itinerant worker, belongs to the union in a particular place, lives in or near the city where he belongs to the union, has a business reason for working elsewhere, does not work for more than a year at any particular place, obtains the work through the union and shows that he regards the city in or near which he lives as his regular place of business by keeping in touch with the employment situation there. ☆

Final expense-account regulations tighten up

FINAL REGULATIONS on expense-account reporting (Section 162-17) differ in a few important ways from the Regulations originally proposed, discussed in our May issue (8 JTAX 282). Because so many firms use reimbursement procedures, you will want to pay particular attention to the changes in reporting requirements there. Basically the rule, as set out in the proposed Regulations, is unchanged: The employee need not report on his tax return reimbursed expenses for which he accounted to his employer. But the final Regulations make it clear that, if expenses in excess of reimbursement are claimed, all expenses must be listed and the amount reimbursed shown.

They also make it clear that an employee is considered reimbursed for amounts charged by him on credit cards even though the payment is made by the employer directly to the credit system. This means that, if the employee wants to avoid reporting all these transactions, he will have to account for them to the employer—perhaps by making sure that the employer gets full information on the business purpose of each item charged.

Another change is applicable to all taxpayers—it specifies the conditions under which the Commissioner will ordinarily require employees to prove their reimbursed expenses. Of course, employees whose expenses are not accounted for to their employers will always have to prove them to the IRS. Ordinarily those who do account for their reimbursed expenses won't have to prove them to the IRS. However, if the employer doesn't require an adequate accounting, the IRS itself requires proof.

Most important, if the employer and employee are related, the IRS will require proof despite the accounting to the employer. So the stockholder-executives of closely held corporations may expect that, for all practical purposes, their situation is unchanged—agents are going to pay attention to and require proof of expenses charged by them to the corporation regardless of the method of accounting they use. ☆

IRS concedes dividend credit is figured on full capital gain

THE CODE allows a credit against tax of 4% of dividends received which are includible in gross income; the credit is limited, however, to 4% of taxable income. That limitation has been the subject of much litigation. The IRS up to now has been insisting that taxable income means after the elimination of partially tax-exempt interest and the 50% of the excess of net long-term capital gain over net short-term capital loss which is excluded from tax.

The courts have been agreeing with taxpayers, and the IRS finally concedes it is wrong—it announces, in TIR 67, that it will follow the rule of the *Springs* case, 153 F. Supp. 514 (reported in JTAX.—*Ed.*) This means that taxpayers who followed the forms in prior years will be entitled to a refund and that, in filing 1957 forms, the computation set out on 1040 and 1041 should not be followed.

Schedule J of 1040 directs the taxpayer to compute the limitation as 4% of taxable income (partially tax-exempt interest and 50% of capital gain excess having been removed). Perhaps the easiest way to use Schedule J correctly is to attach a computation of the dividends received credit limitation on a separate sheet rather than to use line 4 of the schedule. ☆

$10,000-a-year men may now use simplified Form 1040A

THE IRS has announced that taxpayers deriving their income from wages or salaries whose wages reported on form W-2 do not exceed $10,000 and who do not earn more than $200 from other sources may now report on the card form 1040A. The card may also be used for joint returns if the total income of husband and wife does not exceed $10,000. This form was formerly available only to taxpayers earning less than $5,000.

Taxpayers using Form 1040A automatically claim the 10% standard deduction. If a taxpayer has allowable deductions in excess of this amount and wishes to itemize them, he must use Form 1040.

Form 1040A is the size of the usual bank check and has only 15 items to fill in. All that has to be done is to provide the 15 items of information, attach copy B of form W-2 and mail it in. More than 14 million persons used this streamlined method of filing in 1957 and the IRS estimates that 31 million may do so in 1958. As a further simplification, a taxpayer whose income is less than $5,000 may, as in previous years, either figure his own tax or have the IRS do it for him, but the law requires that taxpayers earning $5,000 or more must figure their own tax.

Under certain circumstances taxpayers otherwise eligible may not use Form 1040A—if they wish to claim "head of household" or "surviving spouse" status; dividends received or retirement income credit; "sick pay" exclusion; deduction for travel, transportation or "outside salesman" expense; or estimated tax payment credit. ☆

New decisions

Joint social security benefits must be prorated between spouses. If social security benefits are payable to a husband and wife jointly through one check, the separate amount attributable to each must be considered in determining whether either party received more than 50% of his support from an individual, so as to qualify that individual for dependency exemptions. The same rule applies in determining the amount required to reduce the $1,200 limitation for each of them in the event that they receive retirement income. *Rev. Rul.* 58-419.

Exemption allowable only in year support is received by dependent. In determining the proper taxable year to claim an exemption based on liabilities incurred in supporting a dependent in one year not paid until a later year, the year in which the support was received controls, and not the year of payment of the indebtedness, regardless of whether taxpayer is on the cash or accrual basis. *Rev. Rul.* 58-404.

Double penalty for failure to file declaration of estimated tax upheld (Old Law). Under the 1939 Code there are separate penalties for failure to file and substantial underestimation. The court relying on the congressional committee reports, holds that taxpayer, who did not file a declaration, is liable for both penalties. It notes that other courts have held both ways on the subject. *Hansen,* CA-9, 8/4/58.

Distinguished scientist, receiving little pay, can't take travel costs; not "in business." Taxpayer, a research scientist and wife of a professor at the University of California, was appointed in 1949 as research associate in physiology without compensation. She did considerable work there and published extensively. For the period 1951-1953 the "without compensation" aspect of the appointment was modified, and she was granted a salary of $500 per annum. In 1952 she was also awarded $1,000 to help her meet income tax deficiencies arising out of her claims for research and travel expense questioned mainly because she was not an "employee." The court holds the award is not taxable income. The Commissioner did not meet the burden [on him because the issue was raised in Tax Court.—*Ed.*] of showing that it was not a gift. Taxpayer also deducted travel expenses for trips to Europe which she claimed were incidental to her scientific research. However, the court denies the deduction because the university did not require or even suggest that she take the trips, nor were such trips necessary to maintain her status as a research associate. They were important to her research, but that, clearly, had no profit motive. [See comment page 280.—*Ed.*] *Brooks,* 30 TC No. 115.

Artist's work a hobby, not a business; expenses disallowed. An artist who had exhibited paintings over a period of 40 years is denied deductions for business expenses incurred for the period 1952-1954. It was shown that since 1949 taxpayer had no receipts whatever, and the purpose of her art activities was for pleasure, exhibition, or social diversion rather than to earn money. *Hailman,* TCM 1958-165.

Casualty loss not proved. Taxpayer is denied a deduction for a casualty loss to his summer cottage resulting from severe storms. He failed to introduce evidence of the fair market value of the cottage immediately before and after the storms and also failed to show that any loss in value was the result of physical damage rather than a depressed real estate market in the area. *Kendall,* TCM 1958-163.

Failure to file and underestimation penalties imposed concurrently (Old Law). Taxpayer did not file an estimate and, the court holds, did not show reasonable cause; the Commissioner is held to have properly asserted 1939 Code penalties both for failure to file and for substantial underestimation. [Some courts have refused to apply both penalties in these cases under the 1939 Code; under the 1954 Code there is but one penalty; it is imposed on underpayment.—*Ed.*] *Irby,* 30 TC No. 123.

Reliance on accountant does not excuse failure to file. For the years 1944, 1945 and 1946 taxpayer filed the required declarations of estimated tax, but for the years 1947-1951, no estimates were filed. The Commissioner imposed the penalties for failure to file and for substantial underestimation. Taxpayer argued that he placed himself in the hands of an accounting firm and relied on the firm for advice. The court holds that the failure of the accounting firm to prepare the declarations for taxpayer's signature in the mistaken belief that the Bureau was not asserting penalties for such delinquency does not show competence on the part of the firm, and hence does not constitute reasonable cause to excuse the penalties. *McIntyre,* TCM 1958-153.

Part of accident and health premiums is deductible as medical expense. Where premiums are paid on policies of insurance providing indemnity for accidental loss of life, limb, sight and time and also providing for reimbursement of medical expenses resulting from nondisabling accidents, only that portion of the premiums attributable to the medical-expense benefits constitutes a deductible medical expense. *Heard,* 30 TC No. 116.

Stay at resort not allowed as a medical deduction. Expenses of $2,500 incurred while recuperating at a resort hotel in Saratoga Springs is disallowed as a medical expense in the absence of any evidence as to the nature of the illness, or proof that taxpayer went there at the direction of a doctor. *Scura,* TCM 1958-161.

Construction worker on job of indefinite duration not "away from home." Taxpayer lived with his family in Richmond, Va. He accepted employment as an electrical supervisor from April, 1954, to November, 1955, incident to the construction of an atomic energy plant at Portsmouth, Ohio. The court holds the employment at Portsmouth was "indefinite in duration" rather than "temporary," and constituted the "tax home." Accordingly, a deduction for travel and living expenses on the job is denied. *Beck,* TCM 1958-115.

Value of Navy's educational assistance program taxable. The value of educational benefits received by a taxpayer's minor son under the Navy's educational assistance program is not excludible from the son's gross income as a scholarship if the son is obligated to render the Navy services as an employee for a stipulated period after graduation. The benefits are to be considered by taxpayer in determining whether he contributed more than one-half of his son's support in order to claim a dependency exemption. *Rev. Rul.* 58-403.

New excess profits tax decisions

Change in capacity of related corporation does not entitle taxpayer to relief. The purchase of a new plant by a corporation related to taxpayer and having the same stockholders does not constitute a commitment by taxpayer prior to 1940 to any course of action which it consummated after that date so as to entitle it to relief under Section 722(b)(4). Furthermore, although taxpayer commenced business during the base period, it is denied Section 722 relief for failure to show that its average base period net income was an inadequate standard of normal earnings. *Barth Smelting Corp.*, 30 TC No. 113.

Commencement of business not related to inadequacy of earnings; relief denied. A corporation engaged in oil and gas drilling commenced business immediately prior to the base period and sought relief under Section 722(b)(4), claiming its average base period net income was an inadequate standard of normal earnings. Relief is denied upon a finding by the court that taxpayer's base period net income was adversely affected, not by its commencement of business immediately prior to the base period, but by events and circumstances in no way related thereto. *Falcon Seaboard Drilling Co.*, 30 TC No. 114.

Manufacturer of sulphur products fails to qualify for relief. A corporation manufacturing and marketing sulphur products is denied relief under Sections 722(b)(2) and 722(b)(4). It failed to prove that the depression in business during the base period was caused by a temporary economic event rather than a permanent technical advance, or that, after applying the push-back rule, it could construct an average base period net income which would yield an excess profits credit greater than the credits available to the corporation under the invested capital method. *Southern Acid & Sulphur Co., Inc.*, 30 TC No. 117.

Affiliated corporation required to compute its actual excess profits net income. Taxpayer filed a consolidated return with its parent for two months in 1946 and filed a separate return for the balance of that year when it was unaffiliated. Since taxpayer was in existence throughout the entire base period, it is required to compute its actual excess profits net income for 1946 in determining the average base period net income. Taxpayer's contention that for the two month period in which it was affiliated it had no excess profits net income and could therefore use a monthly average computed for the other months in 1946 is held to be without merit. *Underwriters Service, Inc.* CA-9, 7/15/58.

Section 722 relief denied steel fabricator, granted to department store. A fabricator of steel and steel products, although qualified under Section 722, is denied relief for failure to prove that a constructive average base period net income would produce a credit in excess of the lowest invested capital credit allowed. *Havens Structural Steel Co.*, 30 TC No. 119. Section 722 relief is granted a department store which proved a change in the character of the business during the base period. *Lansburgh & Bro.*, 30 TC No. 118.

Sec. 722 relief denied retail store. A retail store which was committed to enlarging its quarters prior to 1940 is denied excess profits tax relief under the two-year "push back" rule of Section 722, for failure to prove that its base period earnings would have been greater had such changes been completed prior to 12/31/37. *Watt & Shand*, 30 TC No. 79.

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"GRIEVOUS SIN OF NEW LAW IS ADDITIONAL COMPLEXITY" —Mark Johnson

MARK JOHNSON, New York lawyer and co-author of the Rabkin and Johnson Service, says the Technical Amendments Act of 1958 "represents one of the strangest conglomerations of tax amendments ever put together." He sends us this observation from his forthcoming edition of "Taxes Today," the monthly comment for the *Service*.

"The new law's 109 sections range the whole area of the income, estate and gift tax chapters of the Code. They vary from highly important substantive changes to corrections of clerical and typographical errors. Of the substantive changes, about a dozen will have widespread effect —most especially the group of sections which were originally introduced as the "Small Business Tax Revision Act": depreciation, stock losses, extended carryback, additional earnings accumulation credit and installment payment of estate tax. Most of the others affect special classes of taxpayers; some are blatantly private relief; others close 'loopholes' so small that the revenue considerations are undiscernible.

"The most grievous sin of the new law, however, is the additional complexity which it adds to an already overburdened Code. Many of the provisions, even very minor ones, require intense study to extract a meaning. And one monstrous provision on collapsible corporations, which begins with a 50-line sentence and continues *crescendo*, defies comprehension by the expert. What Congress and the Treasury seem to have forgotten is that, above all else, a tax law must be *understood* by the taxpayers—not to mention by revenue agents, taxpayers' advisers and judges. It may be granted that the 'man in the street' does not have to understand tax-free corporate reorganizations or trust distributions. But, it would seem that even the most esoteric areas should be understandable by any lawyer or accountant who is familiar with the basic Code. If obtaining the 'correct' tax result in a given situation requires a statutory provision which cannot be understood, then that is the *wrong* result. Some loopholes or hardships are preferable to the theoretically ideal tax which cannot be administered. Unless this principle is understood and applied, we run the real risk that our revenue structure will fall of its own weight." ☆

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

State taxation of federal property still not settled, despite Supreme Court cases

by **JOHN L. NOURSE**

With the widespread use of defense work contracts that give the Federal Government title to equipment and even to plants, the right of the states to tax that property has raised problems of importance to the governments and to the contractors. Though the most recent Supreme Court cases gave the states a victory, Mr. Nourse thinks that a final equitable solution has not yet been reached. In this article, adapted from a recent talk to the National Association of Tax Administrators, he reviews the changing pressures that molded the doctrine of intergovernmental tax immunity and looks ahead at future developments.

THE STATES HAVE WON an important victory in the *Borg-Warner* and the *Murray* cases. There are sound reasons why the states should be permitted to tax Federal property and Federal activities when the Federal Government moves into the industrial field. The Congress should make a thorough review of the hodge-podge of legislation which today permits the taxation of some types of Federal property, provides for payments in lieu of taxes on other types of property and provides outright grants to the states in some cases in which Federal property is entirely exempt. It should adopt a comprehensive plan for the taxation of Federal industrial property by the states.

It should not leave the solution of problems of intergovernmental immunity to the courts. The doctrine of the immunity of Federal property from taxation by the state originated in the case of *McCulloch v. Maryland,* decided in 1819. This ancient set of facts led to the decision. In 1816, the State of Maryland passed a statute imposing a tax upon banks doing business in that state which were not chartered by the Maryland Legislature. The statute was frankly designed to prevent the Bank of the United States from doing business in the State of Maryland and, if the statute had been allowed to stand, the Bank of the United States would have been destroyed. The primary issue was that of the supremacy of the Federal government. In 1819, Chief Justice Marshall delivered his opinion in the *McCulloch* case. He held the statute to be unconstitutional and, in the course of his opinion, uttered the now famous dictum "the power to tax is the power to destroy."

Since that time the courts have followed this dictum and struck down statute after statute upon the theory that various taxes imposed by state governments increased the cost of government, were therefore burdens upon the Federal Government and, accordingly, violated the Constitution.

Over the same period of time, the doctrine was developed that Federal statutes which increased the cost of state government were likewise unconstitutional.

Shortly after his election, President Franklin Roosevelt pointed out that this doctrine was a severe handicap to both the Federal and state governments because the functions of government had so expanded since 1819 that substantial amounts of property and substantial income and business activity were removed from the tax rolls. He also emphasized that much of the benefit of these exemptions went to private persons and that unfair tax advantages frequently accrued to persons dealing with the Federal and state governments.

Roosevelt succeeded in rallying behind him a strong body of public opinion and there is little doubt but that his campaign influenced the thinking of the courts. The United States Supreme Court in a series of cases, the first of which was *James v. Dravo Contracting Company,* (302 U.S. 134) decided in December, 1937, overruled many of its prior decisions and announced in effect that taxes were no longer to be held invalid simply because they imposed a burden upon another government and increased its costs. In both the *Dravo* case and the cases which followed, such as *Alabama v. King and Boozer* (314 U.S. 1) the Government joined with the states involved in urging the court to abandon the old doctrine and to accept the principle that the state could constitutionally levy taxes which were nondiscriminatory in nature despite the fact that they burdened the Federal Government by increasing its costs. The last of the cases in which the Federal Government supported the position of the states was the *King and Boozer* case, decided in November of 1941. When the United States went to war with Germany and Japan, the Federal Government ended its honeymoon with the states.

Curiously enough, the end of this honeymoon coincided roughly with the entry of the Federal Government into industry. I do not think that all of us realize that the problem of the taxation of Federal property and activities today is almost as different from the problem which Franklin Roosevelt attacked in 1937 as that problem differed from the one which confronted Chief Justice Marshall in 1819.

Prior to World War II, the Government did not engage in manufacturing upon a large scale. There were a few Government arsenals scattered around the country and a few shipyards where naval vessels were constructed and repaired. The Government built dams and hydro-electric projects; it engaged in slum clearance and the construction of housing projects, but it purchased the goods which it needed for its operations from private industry.

However, with the outbreak of the war, the Government found that it was necessary for it to provide the capital to build synthetic rubber plants and to expand the airplane industry, the shipyards, the aluminum industry, etc. Funds for these purposes were provided in a variety of ways: through the Maritime Commission, the Defense Plant corpo-

ration and directly by the War Department and the Navy Department. Private capital was not available for a crash program of this nature and the Government was forced to provide the capital.

The *Mesta Machine Company* case marked the end of the honeymoon between the states and the Government in the courts and it illustrates one of the methods used to finance private industry. That case, entitled *United States v. County of Alleghany* (322 U.S. 174) was decided in May of 1944. The Mesta Machine Company was engaged in the manufacture of heavy machinery. It entered into a contract with the Government to manufacture heavy field guns. The Government paid for the necessary machinery to be used in the manufacture of the guns and its contract provided that title to the machinery should be vested in the Government. The County of Alleghany levied a tax upon the manufacturing plant, that is, upon the land, the buildings and all of the machinery located in it. The Court held that, although the tax was assessed against the private contractor, it was in effect a tax upon the Government's property and that it was therefore invalid under the Constitution. The case was signficant for two reasons. First, because it demonstrated a reversal of the Government's attitude, and, second, because the court restricted the principle of the *Dravo* and the *King and Boozer* cases by imposing a new limitation. The court said that, even though the tax was levied upon a private contractor, the court would examine it closely to determine whether it was "in effect" levied directly upon the Federal Government or its property. It also showed that the court was still concerned with the theory of Federal supremacy.

If there was any doubt remaining as to the Government's change of heart, it was resolved, at least in the minds of those of us who read the Solicitor General's brief, in the case entitled *Reconstruction Finance Corporation v. County of Beaver* (328 U.S. 204). This case did not involve any question of constitutional law. The statute which created the Defense Plant Corporation and the statute which created its parent corporation, the Reconstruction Finance Corporation, each provided that the real property belonging to the corporations should be subject to local taxation. An issue arose as to whether machinery permanently installed in a manufacturing plant was taxable as real property under the terms of these statutes. In his brief, the Solicitor General argued that Congress had intended only to provide that *real property* acquired by the Defense Plant Corporation should not be taken off the tax rolls and that those states which attempted to tax machinery belonging to the corporation were "profiting by the war necessities of the nation." I appeared in that case for the State of California as an amicus curiae and devoted a substantial part of my argument to an attempt to convince the court that this statement was untrue, that, when the Federal Government builds an industrial plant in a community and brings into it a group of workers, it creates serious problems for state and local government, that the Federal Government could not operate an industrial plant unless the services provided by state and local government were available to it and to the workers in the plant, that the Government had to pay for these services just at it paid for gas, electricity and water and that it was in fact paying for them in one way or another—either through taxes, payments in lieu of taxes or grants to local government.

Industry, whether private or Government-owned, cannot exist without police and fire protection; without streets and highways for access to the plants, or without schools for the children of its workers. If Government-owned industry does not pay its fair share of the cost of providing these services, the burden falls upon private industry in the vicinity and upon local residents, including the workers in the Government plant.

The problem today is of even greater magnitude than it was in 1946. Since 1946 everything has grown. The Government is participating in private industry upon a larger scale; the cost of operating the Federal Government has gone up by leaps and bounds; the cost of state and local governments has increased.

I do not think that you are ever going to find a truly satisfactory solution in the courts; you must turn to Congress.

First, let us examine what has happened in the courts since 1944 when the *Mesta Machine* case was decided.

In 1946, the states won the *Beaver County* case involving the interpretation of a Federal statute. The decision was unanimous.

In January 1952, Tennessee lost the case of *Carson v. Roane-Anderson Co.*

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(342 U.S. 232). This was a sales tax case which involved the interpretation of a Federal statute. I think that the interpretation was unduly broad and I would like to point out to you that in that case the court was unanimous. In May, 1953, *Esso Standard Oil Co.* (345 U.S. 495) was decided. The Court upheld a tax levied on a U. S. contractor for the privilege of storing gasoline. The Court divided 6-2.

In February, 1954, the Court decided *Kern-Limerick, Inc. v. Scurlock* (347 U.S. 110). In that case the Court held that the states could not tax sales to Federal contractors where the contractor was purchasing as an agent of the United States. The decision distinguished the *King and Boozer* case on such narrow grounds that it led many to believe that the Court was ready to overrule its earlier decision. The vote was 6-3. Certainly, that case was a real blow to many states which rely upon the sales tax as an important source of revenue.

Now, in the recent *Borg-Warner* case and the *Murray Corporation* case, the Court has said that the states may tax a private contractor for the privilege of possessing Government property, that it may measure the tax by the full value of the property and that it is immaterial what the technical legal incidence of the tax may be.

This is an important victory for the states. For all practical purposes, the *Mesta* case, *United States v. Alleghany County*, is overruled. At least the Court has pointed out a way by which state legislatures can avoid the result of that decision. In his petition for rehearing, the Solicitor General accepted the decision in the *Borg-Warner* case. He attacked only the decision in the *Murray Corporation* case and his attack was not based upon fundamental constitutional grounds. He conceded that, if the Michigan statute involved in the *Murray* case had been the same as the one involved in the *Borg-Warner* case, the result should have been the same. In other words, so far as the United States Supreme Court is concerned, the states are now free to tax Federal contractors in such a way that the states will suffer no loss of revenue by reason of the fact that title to property in their

possession stands in the name of the Federal Government, and the Solicitor General has accepted this principle.

However, it is difficult to say at this juncture just how significant these cases will prove to be from a long-term standpoint. I will not be convinced that the states are to have the right to tax Government in industry as private industry is taxed, at least until the ghost of the *Kern-Limerick* case is laid to rest.

There are suggestions in the court's opinions of last March that a different result might be reached if a corporation in possession of Government property were an agent of the United States. The same suggestion appears in the Solicitor General's petition for rehearing.

If this distinction between ordinary contractors and contractors who are agents is to be drawn, the fruits of this recent victory can be taken away from the states by relatively simple changes in the government's contracts.

The mail truck being driven down the street by a Federal employee is in the possession of an agent of the United States. It is perfectly obvious that the court will not permit the states to tax the mail truck and it is equally obvious that the states should not have that right.

Therefore, we can start by ruling out the taxation of property in the possession of those agents of the Government who are its ordinary employees. Justice Black so indicates in his opinion in the *Continental Motor* case. But what then of an industrial plant entirely owned by the Government and operated entirely by Government employees acting under some form of management contract with an industrial concern? This is the type of arrangement which was used by the Defense Plant Corporation during World War II. The entire plants were owned by the Government and the employees in the plant were Government employees. Private industry simply received a fee for providing its management skills. It had no interest whatever in the profits of the enterprise. The legal distinction between this arrangement and the status of the mail truck is at best fuzzy.

In a situation such as this, the recent decisions would be of little aid to the states. On the other hand, it is obvious that a plant owned and operated in this manner creates problems for local government which are identical with those created by a privately owned plant. The solution, as I see it, must be found in legislation. And there will be no legislation until there is recognition by Congress of the basic proposition that Government in industry must pay its way just as private industry pays its way, and until there is recognition by Congress that, even as an uncontrolled power to tax can become a power to destroy, so the power to exempt from taxation can become the power to destroy.

Mr. Justice Black suggests recourse to the Congress in his opinion in the *Borg-Warner* case. He points out that Congress can permit the taxation of property which would otherwise be immune and that it can also confer immunity by statute where it does not exist under the Constitution and he says, "wise and flexible adjustments of inter-governmental tax immunity call for political and economic considerations of the greatest difficulty and delicacy. Such complex problems are the type of thing which Congress is best qualified to resolve."

Congress has, of course, frequently recognized that the Government should bear a share of the cost of local government when it goes into industry. It has provided for the taxation of some types of Government property. It has provided for payments in lieu of taxes in some cases, and it has said that, where no such payments are made to local government or where such payments are insufficient, funds will be granted directly to local government for the support of other vital functions of the state and the local governments. I think that, as the Federal Government continues to expand its activities in industry, it is becoming more and more important that the right of the states to tax this property be recognized; that Federal grants will not be a satisfactory answer to the problem. If state and local governments are to retain any independence and virility, they cannot rely upon such grants.

The arguments against permitting the states to tax Federal property are that there is danger that the states will discriminate against the Federal Government and an argument to the effect that the supremacy of the Federal Government must be recognized and that it is neither fit nor proper that states should exert any form of authority over the Federal Government.

I do not believe that discrimination would be a serious problem. Certainly, the courts would protect the Government against discrimination and, if that were the only problem, I am sure that some solution can be found which would be preferable to a denial of the right to tax.

In any event the Congress is the only agency which has the facilities to make a comprehensive study of the problem; to decide upon a fair solution and to lay down a set of rules which will reach a consistently fair result. The courts lack the research facilities. Of necessity they deal with the problem piecemeal. They are guided and sometimes controlled by precedents arising out of different economic and political backgrounds. They are, in fact, struggling to find answers to questions which lie outside their proper field of activity only because the Congress has failed to perform its proper function. ☆

N. Y. State Tax Commissioner shows enforcement limit with short staff

UNDUE LEGISLATIVE ECONOMY has seriously hampered the enforcement work of the New York State Tax Department but it has led to the adoption of some ingenious methods of compensating for personnel shortages, Commissioner George M. Bragalini said at the recent meeting of the National Association of Tax Administrators. He deplored the effect of inadequate personnel on the collection activities of his department and indicated some of the measures he was taking to expedite matters.

"In New York," the Commissioner said, "we have repeatedly demonstrated that, for each additional dollar spent in enforcement, we are able to show a return of at least $10 in additional tax." The department, however, is now faced with a backlog of more than 400,000 delinquency cases, representing a potential revenue of about $50 million, and it would take 1,300 additional employees to handle it.

Mr. Bragalini explained that the New York state income tax law is administered with the collaboration of three bureaus—the Income Tax Bureau, "which receives and audits the more than five million returns, maintains the files, collects the bulk of the tax—which this year will total over $570 million—

issues assessments and installment bills and operates an elaborate delinquency control system based on employers' reports"; the centralized Collection Bureau, "which gets all delinquency cases after the Income Tax Bureau has made one or more unsuccessful attempts to collect, and the Special Investigations Bureau, which handles all cases involving possible fraud."

The basic operation of checking returns against employers' reports, which is known as the "105 Operation" from the form number of the employers' reports, is an enormous clerical task. It involves checking over five million returns against a roughly equal number of employers' reports—the handling of over 11 million items, each of which is converted into a punched card for automatic machine match. In the past fiscal year this operation brought to light nearly $12 million of additional tax liability. To date more than $5.3 million of this has been collected and $6.6 million is in the process of collection.

"But that," he said, "is only part of the income tax enforcement story in New York. Income Tax Bureau desk audit of returns last year resulted in $10.8 million of extra assessments. Field audit produced another $3.7 million. And our men, working in the six New York districts of the Internal Revenue Bureau, picked up extra Federal tax assessments which resulted in nearly $2 million of state tax assessments." Despite this showing, Mr. Bragalini is dissatisfied. He feels that much more can be done, pointing out specifically that every phase of the enforcement operation has a huge backlog. How far back this extends, he does not indicate.

"I cannot begin to estimate," he said, "the cost of inadequate enforcement in the specialized income zones, but it must be very considerable—not only in New York, but elsewhere throughout the nation.

"And the longer our state legislatures fail to recognize the problem and help the administrator meet it, the greater the loss of revenue so desperately needed for schools and roads and health and the many other costly programs of government," he continued.

Tangential, but important, to the problem, he mentioned the two-year statute of limitations on criminal fraud in New York. Despite repeated requests to make it conform with the Federal (six years), no legislative action has as yet been taken.

In the face of current shortages in personnel, Mr. Bragalini indicated that an electronic brain would be pressed into service to expedite the process of auditing. "It's obvious," he said, "that we cannot make a detailed audit of some five million returns. All of them get a screening but, as a practical matter, we must concentrate on those which seem most likely to be productive of additional revenue because they bear the earmarks of possible under-reporting of income or overstatement of expenses, personal deductions or exemptions." The State Department of Audit and Control has an IBM 650 electronic brain which is available to the Tax Department, which does not have the funds to buy or rent such a machine, on a part-time basis. The plan is to select returns and translate the information to

punched cards. The machine will then be able to test the cards for unusually large deductions. All returns showing large income would get detailed audit and, in addition, smaller returns which the machine indicates are out of line with normal expectations of deductions and exemptions will be scrutinized. Preliminary tests indicate that this plan would be effective and, if adopted, it will result in concentration of auditing effort on out-of-line returns likely to yield additional revenue, rather than wasting time on detailed audit of returns that seem accurate and regular.

"But even this plan is not the final answer," he concluded, "even if it works. You can't send machines out into the field to conduct audits, nor can electronic gadgets establish the essential personal contact with tax dodgers and delinquents which is at the heart of the collection problem. So we will have to continue to try to prove our case for more money and more help to reluctant legislators. If we persist, we may yet convince them it's good business to spend one dollar to get ten dollars from a tax dodger." ☆

Do state taxes play part in plant location plans?

THE QUESTION of just how far tax considerations influence industry in the selection of new plant sites is being given serious consideration by several states campaigning to attract new industries. More and more state and local governments have been instituting tax studies with the aim of promoting revenue increases without destroying the "favorable business climate" of the locality. (See 7 JTAX 18.)

A recent survey made in Michigan, "Taxes and Plant Location in Michigan," by business executives and members of the University of Michigan faculty, drew the conclusion that "taxation as a factor in industrial location is rarely of primary importance." It stated further: "It is particularly clear that at the state level no clear relationship between tax burdens and industrial growth can be shown." This Michigan group finds nothing alarming in the fact that Michigan, an admittedly high tax state, is lagging behind the rest of the nation in rate of industrial growth. The group reports that "local taxes are probably more significant than tax burdens at the state level. Nontax factors are more likely to determine the state in which a plant will locate, while the local tax situation may play an important part in the decision on where to locate within a state."

On the other hand, Harlow H. Curtice, president of General Motors, has stated that taxes do play a major role in the decisions of his company as to where a new plant should be constructed.

The Detroit *Free Press* has quoted Mr. Curtice as saying: "The present level of business taxation in Michigan has already led us to locate plants in other states, where the taxes per General Motors job are less than one half of the present taxes per job in Michigan. . . . This will also be taken into consideration in the placement of additional plants."

Also, Michigan taxes on industry have led Jones & Laughlin Steel Corporation to locate a 16-million-dollar plant in Ohio, rather than in Michigan, according to an official of that corporation.

New state & local decisions

New York City taxes Steinbeck. An author who resided in New York City and negotiated contracts for his writings through literary agents located there was held subject to the New York City gross receipts tax. The author contested the assessment on the ground that his activities in New York City did not constitute a business or profession within the meaning of the statute, that the tax violated Federal guarantee of the freedom of the press, and that the tax, levied in part on royalties derived from interstate and foreign commerce, violated the Commerce Clause of the Federal Constitution. In denying the taxpayer's claim, the court held that the profits he derived from his literary endeavors demonstrated conclusively that he was carrying on a business, profession or commercial activity as those terms are commonly understood. It found no validity in the taxpayer's contention that the tax violated the constitutional guarantee of the freedom of the press since it applied not only to writers and publishers, but to all businesses, trades, professions, etc. No issue of interstate commerce was involved, the court held, since the tax was imposed on the proceeds from contracts which related to the taxpayer's writing and not to the subsequent sale of literary material by others. *Steinbeck,* Ct. Apls., N. Y., 5/1/58.

Wisconsin denies loss deduction by merged corp. Five Wisconsin corporations which merged in 1950 sustained net business losses in one or both of the two preceding years. The merged corporation in its 1951 tax return deducted the losses incurred by the five corporations. Wisconsin's income tax law allows a taxpayer to offset such losses against the net business income of the following year and, if the deduction is not all used, then the remainder may be applied against the income of the next following year. The court disallows these deductions. Under Wisconsin law, the privilege of taking such deductions is confined to the identical taxpayer who sustained the loss, and a merging taxpayer may not receive a tax advantage over others who have not merged. Upon merging, the court said, the merging corporations cease to exist and but one entity, the surviving corporation, remains. *Fall River Canning Co.,* Sp. Ct. Wisc., 4/8/58.

Assign road sales to home office. Kentucky's income tax statute apportions receipts from sales to the office, agency or place of business of the corporation at which the transactions giving rise to the receipts are chiefly negotiated. At issue here was the apportioning of "on-the-spot" sales made in Indiana by the corporation's drivers operating out of Louisville, Kentucky. The company contended that the truck drivers operating in Indiana were the agencies which negotiated the sales in question and that the particular route of each driver constituted a "place of business" in Indiana. The court, however, rejected this theory. It ruled that the terms "agency," "office," and "place of business" implied definiteness of position and that the drivers were permanently working out of the corporation's office in Louisville, Kentucky. *Coca-Cola,* Ct. Apls., Ky., 2/28/58.

The reports here on significant new state tax decisions are provided through the cooperation of the Federation of Tax Administrators. They are adapted from Tax Administrators News.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA,
JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

No credit to parent though it was liable for subsidiary's tax

THE TAX CREDIT of a foreign partnership, treated as a corporation under U. S. law was the perplexing problem before the U. S. district court (for the first time, we believe) in the recent case of *Abbot Laboratories International Company,* 160 Fed. Supp. 321. The taxpayer corporation, Abbot, owned a 95% interest in two S. R. L.'s (Sociedad de responsibilidad limitada), one in Argentina and one in Colombia.[1] The tax for which Abbot sought credit was on the income of the S. R. L. It was stipulated that, under local law, Abbot, the parent, was primarily liable for the income taxes although they, and a Colombian patrimony tax, were paid by the S. R. L's.

Taxpayer took the position that the amounts of the income taxes paid by the S. R. L's. were constructive dividends to it and it claimed a credit for all of these income taxes as though paid by it under Section 131(a) of the 1939 Code (presently Section 901).

The court addressed itself first to the question as to whether the amount treated by Abbot as a constructive dividend could serve as the numerator of the fraction contemplated by Section 902, which states:

"For purposes of this subpart, a domestic corporation which owns at least 10% of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits."

The Code specifically defines the term "accumulated profits" as, in effect, profits after taxes. From this the court concludes that, since the amount which the taxpayer sought to include as a constructive dividend was the income tax itself, it could not qualify as a dividend for the purpose of Section 902 because the accumulated profits are defined as profits after taxes. Since the constructive dividend would consist of the tax itself, the "accumulated profits" remain undiminished. Consequently, the dividend cannot be said to have been paid out of the "accumulated profits" upon or with respect to which the foreign tax was paid. This position seems to be technically sound. However, in some other respects the reasoning of the court is somewhat strained. It is clear that under normal principles of tax law, a shareholder would be charged with a dividend in every case where his corporation discharges his personal liability. The court ignored this normal rule in order to reach its result.

The court then went on to say that plaintiff did not pay the income taxes in question. The court cites and discusses at length the *Biddle* case, 302 U. S. 573 (1938). The relevance of that case to the instant situation is somewhat difficult to perceive. In *Biddle* the Supreme Court held that the tax imposed by the United Kingdom on dividends was not paid by the shareholder because under the British law the shareholder was not directly liable for the tax.

In the *Abbot* case, however, it was stipulated that the legal duty to pay the tax was laid in the first instance upon Abbot, the parent. Nevertheless, the court, still relying on the *Biddle* case, held that the meaning of words under Section 131 does not have to be determined by foreign statutes. Relying on the separate entity of the S. R. L.s and noting that the S. R. L.s paid the tax, the court denied any direct credit to the taxpayer. The court distinguished the *Dexter* case, 47 BTA 285,[2] and similar cases on the ground that there the portion of the taxpayer's foreign income which was taxed abroad, but which was not taxed here was not taxable here at any time, whereas in the *Abbot* case the tax sought to be credited was imposed by the foreign country on income which was not presently taxable here, but which would most certainly be taxable when distributed to the taxpayer.

While we cannot fully endorse the technical reasoning of the court, the result it reached appears to be correct. Furthermore, the court's decision does not in any way destroy the right of the taxpayer to the foreign tax credit if we accept, as we must, the United States' characterization of the S. R. L.s as corporations. The credit will be allowable when the earnings are actually distributed. Were there no conflict in characterization in the laws of the two countries, i.e., if this were admittedly a corporation under both laws, the result would not be subject to question. Since the character of a business entity in this situation is clearly to be governed by our law, the court was correct in according to the taxpayer in this case the same treatment that it would have got had it owned stock in a corporation which was also characterized as such by the foreign country. We would agree with the result, therefore, since the taxpayer will receive a foreign tax credit by operation of Section 902 upon distribution of the income by the S. R. L. It is to be hoped that the Commissioner in fairness will not then argue that the income taxes paid by the S. R. L. are not eligible for credit because technically under local law they were imposed on the shareholder.

The court was apparently not fully persuaded by its own reasoning and admitted by implication that it was merely trying to attain a fair and equitable result and justifying it the best way it could. It gratuitously inserted the dictum that a stockholder who cannot qualify for treatment under Section 131(f)[3] and who has no control over the distribution of the profits of a foreign corporation should on these facts be given credit under subsection (a)[4] where it appears that the tax paid by the corporation has been levied against him and where he stands to lose the credit if he were to wait for distribution. Obviously, if under the circumstances under consideration the taxpayer did

not pay the tax paid by the corporation, he cannot under any circumstances be entitled to a foreign tax credit. The court apparently limited the application of its reasoning to cases where it yields the correct result.

It should be noted that, even if a taxpayer under these circumstances is considered to have paid the tax, it would do him very little good unless he had some other income from sources within the foreign country involved. This is so even if the court were to admit that in this situation the amount of the tax constituted a constructive dividend.

This whole problem is another instance of the difficulties frequently encountered in the foreign tax credit area as a result of conflicting concepts between the foreign and domestic tax laws. A comparable situation (difference in tax base) was considered in the *Dexter* case cited by the court in its present decision, and was ultimately resolved by subsequent cases and rulings. Although in the *Abbot* case the taxpayer was afforded some rough measure of justice, it may not always be possible under the current statute to achieve a fair result in comparable cases. Certainly, if the taxpayer should be whipsawed by the technical argument that the income taxes, though paid by the S. R. L., were technically imposed upon the shareholder and, therefore, no credit is allowable even upon ultimate withdrawal of the income, the situation would be intolerable. Gross inequity would then result unless the *Abbot* case were overruled or the suggested technical argument struck down. In any event, we have probably not yet heard the last word on this subject.

The decision of the court in respect of the Colombian patrimony tax is worthy of only a passing reference. There can be no quarrel with its determination that that tax is not an income tax or a tax in lieu of an income tax within the meaning of Section 901. In also denying the taxpayer a deduction for the tax, the court once again demonstrated the difficulties frequently encountered by the forced application of general provisions which were enacted purely with an eye to the domestic situation and which produce strange results when applied to the international situation. Relying on a rather obscure provision of the Code which allows a corporation a deduction for taxes imposed upon shareholders in respect of their interest as shareholders, and which are paid by the corporation without reimbursement from the shareholder, the court held that the deduction is available to the S. R. L., but that under the statute the deduction is not allowed to the shareholder since the patrimony tax is clearly imposed upon a shareholder upon his interest as a shareholder. The court admitted that the deduction conferred upon plaintiff's subsidiary has no meaning, but it considered itself helpless to avoid application of the section. Its decision was reached reluctantly and is accompanied by a recommendation that Congress consider the problem with a view to rectification. ☆

[1] During the taxable years in question, the taxpayer itself earned some income directly in those countries. That income, however, was not taxed in either Argentina or Colombia.
[2] In *Dexter* it was held that a credit is allowable for a foreign tax paid on income excludible in the U.S. income tax computation.
[3] Credit for corporate stockholder in foreign corporation that paid the tax; now Section 902, 1954 Code.
[4] Credit for foreign tax paid by taxpayer; now Section 901, 1954 Code.

Foreign tax credit for year applicable despite contest

In *Rev. Rul.* 58-55, IRB 1958-8, the Government announced its decision to follow the *Cuba Railroad Company* case, 124 Fed. Supp. 182 (SD N. Y. 1954), which we previously discussed (see 2 JTAX 168). It will be recalled that, in that case, the taxpayer had claimed that taxes paid to Cuba constituted a proper accrual for foreign tax credit purposes for the year to which the taxes are related, even though the taxes were contested and paid in a later year.

The court held that the doctrine of the *Dixie Pine* case (that a tax cannot be deducted as accrual while taxpayer is still contesting it) was not applicable to this type of situation. We commented that the result seemed eminently correct in view of Section 905(c) of the Code, which provides for a method of correcting the foreign tax credit in cases where the amount of taxes paid differs from the amount accrued.[1] We felt that the rejection of the *Dixie Pine* rule in the *Cuba Railroad* case was correct, both because of Section 905(c) and also because of the provision[2] affording the taxpayer a right to use the accrual method in computing the foreign tax credit, regardless of his method of accounting, a right clearly designed to permit the taxpayer to claim the credit for foreign taxes in the year in which the income is reported. Without such a right, the basic objectives of the credit might well be defeated in cases where the taxpayer has no income from the foreign country in the year in which he pays the foreign tax.

In *Rev. Rul.* 58-55 the government announces its agreement with the case and indicates accord with both our reasoning and our conclusions. However, it continues to say that, for the reasons indicated, the *Dixie Pine* rule will not be applied in the foreign tax credit area and that the ruling would not be applicable, where adverse to the taxpayer, to taxes in respect of a taxable year ended before February 24, 1958.

Except in a rather unusual situation, there seems to be little occasion for any other rule than the one enumerated in the ruling, and to the extent the Commissioner has ever ruled otherwise, his position was untenable.

For example, if a taxpayer incurs taxes in a foreign country and admits a liability for $100, but the Government claims $500 and he contests the excess, he would accrue only $100. If he should lose his case with the foreign government and end up paying $500, the application of Section 905(c) would appear to require that the additional $400 be related back to the year in which the tax liability arose. The *Dixie Pine* rule admittedly still applies to the extent of denying the taxpayer a credit for the $400 so long as he is still contesting liability. In the same case, if the taxpayer denied any liability and then was forced to pay $500, arguably there was no accrual at all in the year to which the taxes relate and, therefore, but for the *Cuba Railroad* case and Rev. Rul. 58-55, the taxpayer would be forced to apply the doctrine of the *Dixie Pine* case.

In cases where the taxpayer admits to some tax liability, Section 905(c)

[1] "If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary or his delegate, who shall redetermine the amount of the tax for the year or years affected."
[2] Section 905(a), which provides "the credits provided in this subpart may, at the option of the taxpayer and irrespective of the method of accounting employed in keeping the books, be taken in the year in which the tax of the foreign country or the possession of the United States accrued . . ."

would always require that the taxes be credited in the year to which they relate unless the deficiency is viewed as a separate tax, distinct from the accrual actually made (seemingly a rather unusual concept). If this view of Section 905(c) is correct, the position taken in the ruling with respect to taxes in respect of a taxable year ended before February 24, 1958, makes sense only in cases where the taxpayer unsuccessfully denies any liability for the tax assessed against him. ☆

New decisions

Child care expense deduction available to non-resident alien. A non-resident alien wife, legally separated from her husband, is entitled to deduct child care expenses in connection with her employment within the U. S. Being separated, she is outside the rule that child care deductions can be claimed only on a joint return, forbidden if one spouse is a non-resident alien. A non-resident alien is taxed on U. S. income from employment and is allowed deductions connected with the income; the IRS rules that child care expenses incurred to hold a job are so connected. *Rev. Rul.* 58-434.

Foreign residence less than year; no income exclusion (Old Law). Taxpayer, a U. S. citizen, accepted employment in Ethiopia for an indefinite period. He left the U. S. in November 1951 and first went to Paris to attend to certain business matters there. Having encountered unexpected delays in Paris, he didn't arrive in Ethiopia until March 1952. Unforeseen problems forced his return to the U. S. in February 1953. The court holds that, although taxpayer was a bona fide resident of Ethiopia from March 1952, his stay in Paris was only that of a transient or sojourner, and since he was not a bona fide resident of a foreign country for an uninterrupted period which includes an entire taxable year, he could not qualify under the 1939 Code for the exclusion. [Under the 1954 Code physical presence abroad for 17 of 18 months may qualify foreign earnings for exclusion. — *Ed.*] *Nelson*, 30 TC No. 121.

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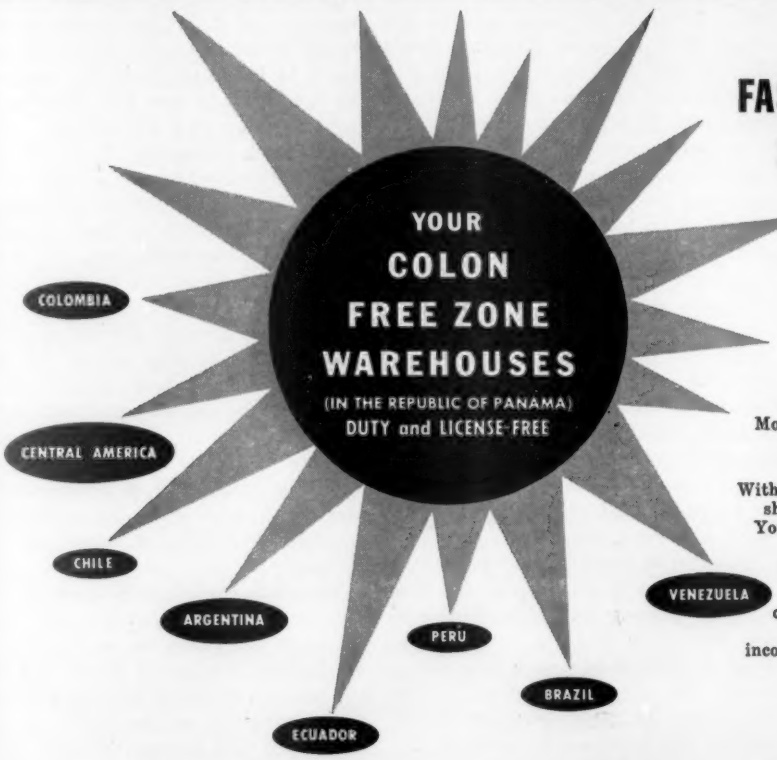

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MANAGEMENT OF THE
Professional tax practice
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Expanding an accounting practice by aiding clients' estate planning

by **LEONARD A. RAPOPORT**

The accountant all too frequently overlooks his unique opportunity to move from mere figure gatherer and tax-form filler into the role of financial counsel personally to the owners of the business which he audits. Stepping up from the routine duties into this personal area means a practice which is more interesting, more challenging and, needless to add, more remunerative. Mr. Rapoport, St. Paul attorney and CPA, talked to the Central States Conference of CPAs recently on the duty and opportunity of the accountant to participate in his clients' estate planning; he adapted this article from his talk.

A RECENT STATEMENT by an Ohio bank spoke of its increasing trust business, developed, it said, by preparing estate analyses for prospects referred to the bank "principally by life underwriters."

The interesting point in this statement is that this new business has been referred to the bank principally by life underwriters, and not by accountants or attorneys. If this does not surprise you, then perhaps a reference to an article by Rene A. Wormser which appeared recently in THE JOURNAL OF TAXATION should make you sit up and take notice if you haven't been aware of the lack of participation by accountants in estate planning:

"Although estate planning is basically a lawyer's job, he needs the collaboration or assistance of contributive specialists. Of these collateral experts, the one least used in practice is the accountant—a circumstance which is often most regrettable for both attorney and client and deprives accountants of employment for which they are uniquely fitted. The explanation may be that accountants generally have not familiarized themselves with estate planning or have not made themselves conspicuously available to give technical aid in this field." (4 JTAX 338).

Although many accountants have participated as members of estate planning councils and many accountants have been actively engaged in estate planning, nevertheless there are many instances in which the accountant has been bypassed, or where nothing has been done in estate planning simply because the accountant has ignored a problem, or made no effort to inform his client. It is important that the accountant be able to recognize existing problems and future needs for estate planning and that he inform those involved of his findings. The accountant's ability to render estate planning service competently depends on his aptitude for the work, the diversity and extent of his general experience, his technical knowledge and the intensity of his feeling for efficiency and sound judgment. The accountant should always recommend that the attorney enter the picture early in the discussion and usually suggest consultation with other specialists practicing in the field, and collaborate with them in a joint effort.

It might be stated that the accountant enjoys a natural advantage in the field of estate planing over other advisers in the field. The frequent contacts that most accountants have with their clients create this advantage in favor of the accountant in estate planning, which should be recognized by both the accountant and the client. Many times in the past the accountant has been kept in the background as a mere gatherer of figures and statistics, either through his inaction in failing to broaden the scope of his work, or by the failure of other practitioners of the estate-planning team to understand and appreciate the possibilities of improved service to their client by a common effort. The really alert and successful attorney, life underwriter, or trust officer welcomes the participation of an accountant on a high level because the accountant does have intimate knowledge of his client's affairs and because of his analytical and coordinating ability. The accountant, in turn, should welcome the participation of the attorney, life underwriter and trust officer, knowing that his client's interests are best served by the specialized know-how of each participant.

Let us consider the audit of a solely owned or closely held business, which is probably the most common organizational form met in practice by most accountants. Far too often the accountant makes his audit, prepares his report and tax returns and considers his service completed until the time of the next audit. If this is where the accountant stops, what has he done? He has told the client in more or less detail what he is worth on an on-going basis at the moment, what he has added to his worth during the prior years and how much he has to pay in income taxes. If he stops here, he misses an opportunity for further service to his client.

Ordinarily, assuming there was no prior audit, sound estate planning would require among other things, an examination in the nature of an audit, possibly without outside verification, but with inspection of documents, contracts, trust agreements, wills, insurance policies, etc., to determine the extent of the property interests of the client and of his immediate family and the existing provisions for the disposition of such property. This examination would include, but not be limited to, the question of valuation, business trend, available personnel and probable liability, and would require the making of suggestions to determine the availability of cash funds to meet such requirements. Much of this information has been made available by the audit and places the accountant in an excellent position to obtain most of the required data with the least amount of inconvenience to the client. If the accountant does not use the audit as a form of springboard to go into the matter of estate planning, he has not furnished the client with the maximum benefit that can be derived from the

audit. This is a relatively new concept and requires an educational program addressed to the client, to the other estate planning practitioners and, yes, even to the accountant himself.

The accountant should feel that he is probably the logical man to initiate an estate plan and effect co-ordination with the estate-planning team. This is more than a mere challenge to the accountant's ability; it becomes his responsibility because of his familiarity with the client's financial affairs and the client's need for estate planning. If the accountant has had contacts with the client over a long period of time, he is also familiar with the client's ambitions and the desires of the client for his family and others.

Further the accountant's broad knowledge of business, financial and tax matters places him in a position to apply this knowledge to the particular needs of the client, and because the accountant is an expert in assembling data and charting it, he can determine just what the present situation is and what its possible consequences might be. Having determined the present situation and its possible consequences, the accountant can suggest changes and can take the changes suggested by the other practitioners and rearrange the charts so as to determine the effectiveness of such changes in accomplishing the client's objectives. The accountant is in the best position because of his continuing contacts with the client to note changes in the client's wealth, his family, his needs and desires and finally, because the accountant understands income taxation and is becoming increasingly familiar with gift and estate taxes, he must play an important part in the success or failure of an estate plan.

The accountant should make certain that the client understands the essentially legal nature of much of the planning and most of the implementation of the estate plan, and that it will be necessary for him to work with the client's attorneys regarding legal matters involved, for the interpretation and drafting of legal instruments is exclusively the work of the attorney, and that it may become necessary to work with the client's insurance underwriter, trust officer or others for the purposes of determining and integrating various other features of the estate plan.

Using the audit performed by the accountant as an opening wedge is just one approach to estate planning. Other means are also available to the accountant. It would generally be a mistake to make a direct approach to the client and say "I would like to examine your estate setup," although in certain circumstances in which the accountant's contacts with the client have been very close, this may very well be the best approach. Various other opportunities present themselves, and the accountant should take advantage of them as they arise. For example, a client calls his accountant and asks what the estate tax would be on an estate of $200,000, $300,000, and $400,000, assuming he was leaving everything to his wife outright. How many accountants would compute the tax, furnish the information to the client and consider their service completed? Here is a situation in which an educational job can begin.

The client has shown that he is interested in what happens after his death, but he may have the common misconception that the size of the tax is the only important factor. In such a case he should be given the information he desires and then be brought around by whatever tactics are necessary to a review of the entire estate plan picture in its full perspective, with the ultimate goal of receiving his consent to make a full and proper study.

Another opportunity might result from a situation in which the client's attorney calls the accountant to determine the value of some piece of property or other asset owned by the client, and advises that he is in the process of drawing a will or trust instrument for the client. The accountant should suggest to the attorney that it would be a good idea at this time to plan together the entire estate of the common client, pooling respective information and knowledge to the best interests of the client. In this instance the attorney would usually like to plan the meeting with the client and should be encouraged to do so.

Still another opportunity might arise if the client has his insurance underwriter consult the accountant because of insurance that he is contemplating buying to fund a buy-sell agreement, or perhaps the client's investment counselor might call the accountant in regard to certain changes in the client's investment portfolio. These are just a few of many situations which may present an opportunity to broaden the scope to an entire estate plan. The particular manner in which the go-ahead sign will be obtained from the client will depend on the facts of each particular situation. The accountant, however, must be sure that, when he is told to proceed, he will know what to do and how to do it.

In just the same manner as the professional accountant is called upon to develop plans relating to the financial aspects of a business and to present the financial figures reflecting the anticipated results of alternative courses of action, so must the professional accountant function in the planning of an estate. He should be thoroughly familiar with the provisions of the income, estate and gift taxes, and with the results which are obtainable through the use of insurance, trusts and various types of provisions in wills. This opportunity for service will prove to be rewarding both financially and in the professional growth of the accountant. ☆

Why object to legal specialization? — a look at fundamentals

THE PROPOSED CODE OF CONDUCT for lawyers employed by accounting firms and accountants employed by law firms [See 9 JTAX 198.—*Ed.*] particularly in the section concerned with solo practitioners who are members of both professions—is thought by many practitioners to be an attempt to settle what is really a problem in legal specialization by requiring the practitioner to suppress all evidence of his specialized qualifications. In the hot debate engendered by the proposed Code, it is sometimes overlooked that, at least from the point of view of the bar, taxation is only one of the fields in which some practitioners acquire narrowly concentrated education and experience. A solution adopted for tax practice will inevitably be used as a guide in other fields, and, accordingly, tax practitioners should bear in mind the more general arguments for and against legal specialization.

The editor of a recent *University of Law Review* editor, Carl G. Paffendorf, has summarized the highlights of the controversy in an article for the Review

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and we report here some salient passages from it.

"In 1954," Mr. Paffendorf noted, "the American Bar Association adopted a resolution stating that it 'approves in principle the necessity to regulate voluntary specialization in the various fields of the practice of the law for the protection of the public and the bar . . . .' It is evident from this resolution that the bar is aware of (1) the growing practice of specialization; (2) the need for its regulation; (3) the undesirable practices resulting from its uncontrolled growth and (4) the benefit to be realized by the public and bar through its control and regulation.

"Soon after the adoption of the foregoing resolution, the ABA appointed a special committee, known as the Committee on Specialization and Specialized Legal Education, to make detailed recommendations as to the action required on the part of the ABA to implement, organize and finance a plan to carry out the principles set forth in the resolution. The committee responded with a comprehensive plan. Essentially the proposals set forth in the committee's plan provided for the creation of a Council of Legal Specialists. This Council was to consist of nine members of the American Bar Association, function under the auspices of the ABA and be responsible to the profession and public as a whole. The purpose of the Council was to make the investigation necessary to determine which fields of specialized practice should be approved and which specialty societies should be recognized in approved fields. It would then establish general standards applicable to all recognized societies. It was anticipated that, after the proposed Council completed its investigation, specialty societies would be authorized in each specialty field which had been approved. Further, after a field of law was approved by the Council for the creation of such society, the lawyers and the existing organizations in that field would form a specialty society in accordance with the general standards of the Council. Such societies would be required to establish and maintain their own minimum standards for membership and practice. Emphasis would be placed upon specialized legal education.

"The recommendations of the Committee on Specialization and Specialized Legal Education were not submitted to the House of Delegates for adoption. The Board of Governors rejected the proposals and dismissed the Committee."[1]

Mr. Paffendorf offered the opinion that these recommendations, had they been adopted, would have constituted a professional contribution of inestimable value to the public and the bar.

Why the objections?

"There are many benefits to be derived by both the public and the profession through controlled legal specialization," he continued. "Its proper cultivation would yield a more learned and proficient crop of attorneys. This would result in the satisfaction of a great public need. The requirements of high educational standards for membership in specialty societies would give rise to the advancement of specialty education in both undergraduate and graduate law school programs. The unethical practices stemming from the uncontrolled and unguided growth of specialized legal service would be substantially reduced and in some cases extinguished. Other benefits implicit in the explanation to the objections to legal specialization would be realized through its control and guidance.

"With the many merits of legal specialization so obvious, why have the proposals for its promotion and control met with such resistance? Apparently it is a result of the unquestioning subscription of the majority to the arguments raised against legal specialization. These arguments, although basically unsound, have gained strength through the confusion and abuses stemming from the unwieldy development of specialized legal service. Many practices traditionally considered unethical (such as advertising and solicitation) have been connected with this development. Other misconceptions, such as specialization leading to the unauthorized practice of law, causing the extinction of the general practitioner and the division of the bar into many self-interested factions, have generated much of the adverse feeling toward specialization and its control.

Advertising and solicitation

"In an effort to maintain professional dignity and to preserve its status above the trades of the common marketplace, the legal profession has traditionally been opposed to advertising and solicitation.

This tradition has much to be said for it. However, as in the case of most traditions, a rigid adherence to the dictates of its restrictions is capable of working hardships and impeding professional progress. From a practical point of view it is extremely difficult for an attorney to set up a specialized practice. Since he is not permitted to hold himself out to the public as a specialist, he must rely upon referrals and upon the occasional client who by chance selects him to handle a problem involving his specialty. He is forced to turn away the general client. Few lawyers can afford to specialize under these circumstances.

"Nevertheless, some attorneys have circumvented the restrictions upon soliciting and advertising in an effort to specialize. They have been reprimanded and in some cases disbarred. Much of the stigma generally connected with advertising and solicitation has, due to the notoriety of these cases, attached to the practice of legal specialization.

"The weaknesses of this misconception can easily be demonstrated. However, the root of the problem lies in whether or not the professional prohibitions against advertising and solicitation should be relaxed to permit an attorney to hold himself out to the public as a specialist.

"At the outset we must remember that advertising and solicitation do exist today and in certain forms are condoned by the profession. The 'shingle,' office

[1] Numerous requests were made by many interested groups for a hearing on the proposed recommendations. The hearing was granted by the Board of Governors (Chicago, Ill., Oct. 14, 1954) and resulted in the rejection of the proposals and the dismissal of the committee. The reasons for Board's action have not been published.

[2] ABA opinion No. 251 (1943).

[3] C. W. Joiner *Specialization in the Law? Medical Profession Shows the Way*, 39 A.B.A.J. 539 (1953).

[4] Familiar activities which indirectly partake of the nature of solicitation and advertising would be those facilitated through social, religious, fraternal, political and family contacts.

[5] A.B.A. CANONS OF PROFESSIONAL ETHICS, No. 46.

[6] *"Notice to Local Lawyers*—A lawyer available to act as an associate of other lawyers in a particular branch of the law or legal service may send to local lawyers only and publish in his local legal journal, a brief and dignified announcement of his availability to serve other lawyers in connection therewith. The announcement should be in a form which does not constitute a statement or representation of special experience or expertness." ABA Canons of Professional Ethics, No. 46 (as amended Feb. 21, 1956).

[7] *"Aiding the Unauthorized Practice of Law*—

door legend and letterhead are forms of advertisement. A professional card handed to a neighbor coupled with words indicating a willingness to serve him is also a form of advertisement and solicitation. The purpose of the rule restricting advertising and soliciting is not transgressed through the allowance of an attorney to hold himself out as such to the public by these means. It is, therefore, difficult to see how this purpose would be violated by allowing him to hold himself out as a specialist in a particular area of law. Nevertheless, as soon as he adds to his 'shingle,' card or letterhead the words 'Tax Specialist,' 'Trial Lawyer,' or 'Negligence Attorney,' he is immediately charged with advertising or soliciting.[2]

"The main argument against advertising and soliciting stems from the practice of some attorneys in holding themselves out as specialists when actually they are little more qualified than the general practitioner. However, this argument would completely fall apart if specialization were controlled, proficiency groups or societies were organized, special qualifications were stipulated for membership and if the right publicly to indicate a specialty were strictly limited to the members of a society. The medical profession, which is just as opposed to advertising and soliciting as the legal profession, has had, through the development and control of specialty societies, considerable success in allowing the medical specialist to indicate his specialty to the public.[3] There appears to be no reason why the legal profession could not enjoy the same success.

"Because of the direct methods of advertising and soliciting mentioned and other more subtle methods[4] which are everywhere taken for granted and because the public representation of a specialty is inherently unobjectionable and ultimately unavoidable, it is difficult to understand how advertising and soliciting could be used to disparage controlled specialization.

Canon 46

"Perhaps the primary sources of the present difficulties with regard to legal specialization arise from the application (and at times the misapplication and inapplication) of the American Bar Association's Canon 46.[5] The adoption in 1933 of Canon 46, although a recognition by the ABA of the growing need for specialization, fell short of the action needed under the circumstances. The application of this canon illustrates the confusion and ineffectiveness implicit in most action by the organized bar short of complete control and guidance of specialized legal service. Canon 46 as originally adopted (and until its amendment on February 21, 1956) provided:

" '46. Notice of specialized legal service. Where a lawyer is engaged in rendering a specialized legal service directly and *only* to other lawyers, a brief, dignified notice of fact, couched in language indicating that it is addressed to lawyers, inserted in legal periodicals and like publications, when it will afford convenient and beneficial information to lawyers desiring to obtain such service is not improper. (*Italics added*).'

"Two problems arose from the application of this canon which involved: (1) the requirement that notice may be sent to other attorneys only if the sender renders the specified service 'directly and *only* to other lawyers'; and (2) the lack of definition in what would constitute a 'specialized legal service.' H. S. Drinker, chairman of the ABA Committee on Professional Ethics and Grievances from 1944 to 1953, pointed out that the first problem rendered Canon 46 totally ineffective. The New York City and New York County Bar Associations ignored Canon 46 for this reason and issued a joint statement providing that an attorney may send a notice to other attorneys 'which includes a statement of intention to specialize.' The Chicago and California Bar Associations shortly thereafter took similar action.

"Finally, in 1956, after 23 years, the American Bar Association amended Canon 46 to its present form.[6] A lawyer may now send notice to other attorneys announcing 'his availability to serve' them in particular branches of the law without precluding him from serving lay clients directly. This step came late, for the ineffectiveness of the original canon led to its disregard by many attorneys. Before long, such disregard drew the connection of legal specialization and unethical advertisement and solicitation closer and closer. This connection, it is submitted, is completely unjustified by present objective reality.

"The second problem, that is, the lack of definition of what constitutes a specialized legal service, still remains. The application of Canon 46 was not limited to any specific group of specialty practices. On the other hand, it was not open to all areas of legal practice. Consequently, this canon has given rise, although apparently unintentionally, to considerable confusion as to what areas of practice are specialty fields. Opinion 194 of the ABA provides that 'whether or not a particular service . . . is a specialized legal service within the meaning of Canon 46 will ordinarily depend upon the extent to which such service is available from members of the bar in the community in which the lawyer is practicing.' Implicit in this statement is the problem of what standards shall be used in deciding which particular service should be recognized as a specialty service in different communities. Obviously, the standards are arbitrary. Furthermore, uniformity in the practice of specialization could not be achieved through the operation of this canon. As a result much confusion has resulted with regard to specialization in the application of Canon 46, and, consequently, with reference to the entire proposition of legal specialization. If the American Bar Association would create a council to investigate, set standards for and regulate legal specialization, would not its guidance obviate all the confusion here engendered?

Canon 47

"This canon of the American Bar Association prohibits lawyers from aiding the unauthorized practice of law. One of the greatest objections to legal specialization is that specialization contributes to the violation of Canon 47.'[7] This argument is entitled to analysis.

"Long recognizing the public need for expert service in various fields interrelated with law (particularly realty, taxation and finance), many lay agencies organized and educated themselves for the call. As these organizations in response to the growing public need expanded in size and proficiency, their bailiwicks accordingly expanded. Areas of practice traditionally within the province of lawyers became subject to the encroachments of lay agencies. The profession became alarmed. However, the traditional restrictions upon attorneys, making it highly impractical for all but a few to specialize, rendered the profession wholely unqualified to cope with the situation. Not only were the competing lay agencies strides ahead of the legal profession and for the most part abreast of public demand, but they were in the enviable position of being able to boast their talents and readiness to serve through all forms of advertising media.

By the time lawyers accepted the challenge, they found themselves working directly or indirectly for trust companies, security underwriters, real estate concerns, tax counselors and CPA's. Now the lawyer is playing on the second team or 'warming the bench' in a game in which fifty years previously he was the whole team, including the coach and water-boy. Is it any wonder that the average income of the lawyer has increased at a slower rate than that of any other profession? Is it any wonder that lawyers are forced to associate in one way or another with lay agencies?

"The misconception here lies not in what is in fact being done, but rather in what should be done to remedy the situation. If the legal profession would promote, encourage and insist upon legal specialization; if it would take control and give guidance to its haphazard growth, and if it would impose standardized qualifications necessitating specialized legal education, the rightful heritage of the profession would then be recovered. The phrase 'unauthorized practice of law' and Canon 47 would then become unimportant symbols of antiquity.

Premature control of specialization

"Another familiar argument directed against the promotion and the control of specialization is that the profession is not ready to make the change nor is a change necessary at this time. Not too long ago a most eminent member of the profession, a specialist for twenty-five years for one of New York City's largest law firms, voiced his objections to the promotion and control of legal specialization. He pointed out that the large metropolitan firm 'with twenty partners and thirty other lawyers in the office [could] develop specialists in quite narrow fields and yet render a well-rounded general service to its clients.' It was then submitted that the legal profession was not 'close to being ready for widespread specialization by solo practitioners and small firms.' This latter conclusion was based upon the premise that the ethical standards of our profession are of such a nature that one attorney has not only the prerogative but the duty to accept the employment of all comers regardless of who referred them or the purpose for which they were originally referred. Consequently, the lawyer's lawyer, it was then prognosticated, would never come into existence as has the doctor's doctor, for the simple reason that the referring attorney could never be certain that he would ever see his client again.

"This all appears to be quite logical. But is it? Are the foregoing conclusions justified when viewed in respect to other important phases of the problem? For instance, who is the only remaining candidate qualified to handle the ever increasing number of specialty problems, in the absence of specialization on the part of individual practitioners and small firms? The answer, of course, is the large metropolitan law firm. Now assuming the validity of the aforementioned premises with regard to our ethical practices, what alternative does the general practitioner in the small firm have when faced with a highly complex specialty problem? He may send the client to the large city firm, a firm capable of handling general service as well as specialized service, and hope that the client will some day return. Or, on the other hand, practical considerations may motivate him to handle the case himself and consequently take the chance that his lack of experience in the specialized field involved will not prevent an efficient and satisfactory outcome. These alternatives do not give rise to a high degree of harmony within the profession or a high standard of service to the public.

"However, suppose for a moment, that specialty societies are created and controlled, that their members are encouraged to practice individually or in small firms, that they are all qualified and certified, and, in addition, suppose that they are permitted to hold themselves out to the public and the profession as lawyers qualified and interested *in one area of law*. These circumstances would justify an entirely different result. The attorney trained and qualified in tax law would certainly be little interested in taking the time from his specialty practice to handle a divorce or negligence case. The general practitioner would, in this case, have little to fear in the way of client loss through specialist reference. The public would ultimately enjoy more expert and fruitful legal service.

"Other objections to specialization and its control and brief explanations of each are summarized as follows:

"1. Specialization will lead to the ultimate extinction of the general practitioner. This objection has little to support it.[8] The great bulk of legal chores will always be within the scope of the general practitioner's activity. Just as the patient who has a trifling ailment and the patient who does not suspect the seriousness of his malady will invariably consult his family doctor, a general practitioner, this would also be the case with the average client and his everyday legal involvements. Furthermore, as the complexity of modern society gives rise to more and more problems requiring the attention of a specialist, this same complexity will create an increasing abundance of ordinary problems requiring the service of a general practitioner.

"2. 'There is a fear that . . . the general public will be unable to get full legal services from one man. . . .'[9] For the sake of argument the truth of that statement will be conceded. But is it objectionable? Surely no one would contend in this day and age that a lawyer is capable of being an expert in all fields of law. When a client occasionally brings to his attorney a problem requiring the attention of a specialist, it is most probable that he would not only welcome the referral of his problem to a lawyer more learned in the subject of his inquiry, but would demand such a referral.

"3. Another objection raised against specialization is that it will add impetus to the growth of self-interested groups and detract from professional unity. This statement is undoubtedly true under existing conditions. However, the only way this situation can be alleviated is through the direction and co-ordination of the various specialty groups by one superintending council or board. These groups, if created and controlled by a council operating under the auspices of the American Bar Association, would be united in purpose, spirit and organization. In this way professional disunity could be avoided.

Conclusion

"The objections raised clearly point out the public and professional need for attention in this area of legal practice. The need must not be ignored; our duty must not be neglected. In this regard, Mr. Justice Harlan F. Stone's words have great significance:

No lawyer shall permit his professional services, or his name, to be used in aid of, or to make possible, the unauthorized practice of law by any lay agency, personal or corporate." ABA Canons of Professional Ethics No. 47 (adopted Sept. 30, 1937).

[8] 79 A.B.A. REP. 584, 589; see also, C. W. Joiner, *Specialization in the Law: Control It or It Will Destroy the Profession*, 41 A.B.A.J. 1105 (1955).

[9] C. W. Joiner, *Specialization in the Law: Control It or It Will Destroy the Profession*, 41 A.B.A.J. 1105 (1955).

[10] Harlan F. Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1 (1934).

" 'Before [the bar] can function at all as the guardian of public interests committed to its care, there must be appraisal and comprehension of the new conditions and the changed relationships of the lawyer to his clients, to his professional brethren and to the public. That appraisal must pass beyond the petty details of form and manners which have been so largely the subject of our codes of ethics, to more fundamental consideration of the way in which our professional activities affect the welfare of society as a whole. Our canons of ethics for the most part are generalizations designed for an earlier era. However undesirable the practices condemned, they do not profoundly affect the social order outside our own group. We must not permit our attention to the relatively inconsequential to divert us from preparing to set appropriate standards for those who design the legal patterns for business practices of far more consequence to society than any with which our grievance committees have been preoccupied.' "[10] ☆

Corporation provides tax help for its employees

TAX RETURNS for 275 of its employees were prepared last year by the estate planning and tax department of a Hamilton, Ohio, firm. Of course, the tax man for a corporation is frequently asked to help, on a more or less informal basis, when executives of the company have personal tax problems and, if capital changes in the corporation are under consideration, he must study the effect on the stockholders' tax position, particularly if the stock is closely held. But it is unusual for a corporation to set up a formal estate planning and tax department for the purpose of providing services to its employees. That is what the Champion Paper and Fibre Company did.

M. D. Conklin, who heads the department, told the Estate Planning Council of Indianapolis recently how the company came to set it up. Mr. Conklin explained that he had been an IRS field auditor for four years, had sold insurance for 11 years and was a trust officer with a Cincinnati bank when, in 1948, he was doing an estate planning job for Reuben B. Robertson, Jr., who shortly thereafter became president of Champion. "Mr. Robertson remarked to the underwriter who brought him into the case: 'If we had had somebody like Conk on our payroll 10 years ago, it would have saved our executives, employees and their families millions of dollars.'

"Out of this idea the present estate planning department developed, Mr. Conklin joining the Company on April 1, 1949.

"When announcement was made to Champion's employees that an estate planning and tax department had been opened, President Robertson said: 'Among other things, Champion should take the leadership in assisting its employees when requested in working out their personal affairs and estate plans. Men and women who have sound professional advice about their finances will be freed from personal worries and will be better workers for the company.'

"During the first three years," Mr. Conklin said, "we planned over 200 estates and worked with 64 attorneys, 52 life underwriters, six accountants and 25 trust companies in 15 states. We helped sell in excess of $7 million of new life insurance and we placed over $45 million of trust new business on the books of these trust companies.

"The department has grown to nine people, seven of whom spend a substantial portion of their time on estate planning, taxes and personal problems of the employees. Our department handles the payroll of all employees who make in excess of $10,000 and, in addition, we handle all the records for this same group in connection with our profit-sharing and deferred compensation plan. This past year we prepared approximately 275 tax returns. We also act as financial secretary for a number of our executive group in the general office.

"The basic philosophy in back of our estate planning and personal service department is that, if we can take some of the employees's problems off their shoulders, it relieves them 'to spend more time on company affairs and devote more time to their families.'

"We spend a lot of time on confidential company and personal assignments. For example, when Mr. Robertson was asked to take the job of Deputy Secretary of Defense, one of the questions was whether or not he would have to sell his stock in the company.

"We do estate planning work in our subsidiaries. We are also called in, occasionally, to look at the tax aspect as well as the estate planning problems as they affect the seller as well as the company in situations where we are interested in acquiring an interest in a converter or merchant.

"We keep the estate planning records in our office very confidential. Every case is given a number. Except for one file, there are no names in the files. In our proposals no names are used. In the event the department should ever be abandoned, these files go back to the individuals; they are not the property of the company.

"Champion has a philosophy which has stood it well over the years and has helped materially in the progress it has made to date. Its employees are its most important asset. Anyone can put up buildings and buy machinery. The difference between companies is the people. As Mr. Robertson told me before I went on the job, 'As I see it, you are going to have a lot of decisions to make where you may have to weigh the employee's problem against that of the company. Don't ever sell the employee short. If it is not good for the employee long range, it is not good for the company." ☆

Bar group recommends regulation of "tax experts"

A JOINT STUDY to draft legislation aimed at the regulation of the activities of "tax consultants" who are neither lawyers nor accountants was recommended by the Committee on Taxation of the State Bar of California at its annual meeting. A resolution was passed recommending that the Committee on the Unlawful Practice of the Law, the Committee to Confer with Accountants and the Committee on Taxation participate in such a study.

In its report, the Committee on Taxation noted that many persons who were neither lawyers nor accountants were engaged in preparing income tax returns for a fee and made a practice of advertising their availability to perform such services.

Although the Committee acknowledges this this may fill a legitimate need, it felt that the public should be protected from misapprehensions as to the qualifications of such persons. Legislation simply prohibiting the use of the phrase "tax expert" in such advertising was considered inadequate, since it still provided no means of assuring the competence of those preparing the returns, regardless of what they chose to call themselves. ☆

PROBLEMS ARISING FROM

Special tax treatment

OF PARTICULAR INDUSTRIES

Congress postpones Treasury-proposed reduction of clay depletion allowances

by **BERKLEY ZIONTS**

Application of the end use test to the problems of clay depletion has long been considered unsound and inequitable by taxpayers and practitioners alike. In this article, Mr. Zionts presents the salient points of the problem of clay depletion and hails as at least a temporary victory for taxpayers the failure of Congress at its last session to adopt the proposals of the Treasury Department in this area.

WITH THE CLOSING of the most recent session of Congress, the hopes of the Treasury Department regarding clay depletion were once again dashed. The situation in this area has not been satisfactory to the Government since the *Cherokee* case [*Cherokee Brick and Tile Co.*, 122 F. Supp. 59 (M.D. Ga. 1954), *aff'd*, 218 F.2d 424 (5th Cir. 1955)], which held in effect, that brick and tile clay producers are entitled to apply their percentage depletion rate of 5% to their total sales of burnt clay products.

The Government strenuously objected to this decision, basing its argument mainly on the fact that Section 114(b)(4) of the 1939 Code [which is the same as Sections 613(a) and 613(c)(1) of the 1954 Code] required the depletion rate to be applied to the "gross income from the property" and that in the case of clay, this means "gross income from mining."

Clay must undergo many processes after the physical mining before it is converted into brick; it must be pulverized, mixed with water, shaped, dried and finally burned in kilns. The Government labeled these latter processes as manufacturing and consequently objected to the fact that a depletion computation utilizing as a base the selling price of the finished brick took into account not only gross income from mining—but also gross income from manufacturing.

Despite the apparent logic of the Government's argument, the taxpayer was successful in repudiating it. This was accomplished by reference to the unambiguous definition of mining contained in Section 114(b)(4)(B) of the 1939 Code [which is the same as Section 613(c)(2) of the 1954 Code]. According to this definition, the term "mining" includes "not merely the extraction of the ores or minerals from the ground but also the *ordinary treatment processes* normally applied by mine owners or operators in order to obtain the *commercially marketable mineral product* or products . . . ." (emphasis added).

It is generally conceded in the industry that there is no market for brick and tile clay until it is manufactured into a burnt clay product. Similarly, it is conceded that the processes applied to the clay by the taxpayer are those "ordinary treatment processes" normally employed by the clay products industry to arrive at commercially marketable products. Consequently, despite Treasury Regulations to the contrary, the taxpayer was successful and a long line of cases began to accumulate behind the *Cherokee* decision.

One of these cases happened to be the *Acme* case. [*Acme Brick Co.*, 160 F. Supp. 604 (N.D. Tex.), *aff'd*, (5th Cir. No. 16572, 4/25/57, *cert. denied*, 355 U. S. 824 (1957)], a case dealing with refractory and fire clay. Although the outcome of this case was also favorable to the taxpayer, it might serve to introduce the reader[1] to two problems which do not occur in the brick and tile clay industry but do occur in the refractory and fire clay industry.

The first of these difficulties lies in determining what constitutes fire clay for the purposes of the depletion allowance.

According to *Rev. Rul.* 56-59, clay qualifies for the 15% refractory and fire clay depletion rate if it is *used* in the production of refractory items. Thus the end use test has been adopted, thereby disqualifying about 50% of the annual refractory and fire clay production from the 15% rate and instituting a 5% rate in its place. This is due to the fact that about 50% of the total refractory and fire clay production is used for non-refractory purposes.

It seems doubtful that the imposition of the end use test will be upheld in the case of refractory and fire clay, based on the following reasoning: (1) The Code puts no restriction on refractory and fire clay depletion based on the use to which the clay is put. This point is emphasized by the fact that the 1954 Code does adopt a limited version of the end use test in regard to certain minerals —but not refractory and fire clay. (2) The concept of the end use test has been highly criticized by members of both the legal and accounting professions. This is due basically to the fact that such a concept overlooks a vital factor in the rationale behind depletion. The depletion concept recognizes the fact that the exploitation of a natural resource inevitably results in the exhaustion of that resource; consequently, when the result of such exploitation is taxable income, the amount of this income should be reduced by an allowance approximating the value of the used-up resource. Logically, is the value of the resource used up dependent upon the use to which it is subjected? (3) Finally, it is of interest to note that all the examples cited by the Government in its rationale of the end use test in the case of fire clay have been rejected by the courts.

The other difficulty lies in determining what is the first commercially marketable product. This question has been settled by the court in the *Acme* case which held that the burnt clay product was the first commercially marketable

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[1] A much more extensive analysis of this problem may be found in a note by Mr. Zionts entitled The Clay Depletion Controversy in University of Pittsburgh Law Review, Vol. 20, No. 1 (Fall 1958). Office: 1401 Cathedral of Learning, Pittsburgh 13, Pa. Price of single issue: $1.50.

item, thereby holding squarely in accord with the *Cherokee* case, despite the fact that a considerable amount of raw fire clay is sold prior to its undergoing manufacture into a burnt product. The basic reason why the court discounted these sales seems to have been that they were made by only a very small percentage of refractory and fire clay producers. Nevertheless, this factor appears to be the most controversial matter to be solved in determining future depletion allowances for this type of clay.

However, had the Treasury Department's proposed legislation been adopted this session, most of the above problems would have been solved—in the Government's favor. This legislation would have the effect of delineating between mining and manufacturing processes, thereby specifying the processes allowed to be included in determining a taxpayer's gross income from mining. In addition, it would put into law the infamous end use test, by providing that all clay, when used to manufacture brick and tile products, shall be limited to a depletion rate of 5%.

A primary purpose for the adoption of percentage depletion was the achievement of simplified computation and the corresponding reduction in controversy due to this simplification. It is submitted that the proposed legislation, with its somewhat arbitrary cut-off points, controversial income allocations and highly criticized concepts such as the end use test, would operate contrary to this end. As such, its failure to be adopted at the last session of Congress will probably not be too greatly mourned by practitioners in the tax field. ☆

New decisions affecting special industries

Co-operative housing corporation may rent commercial space. The rental of commercial space in a co-operative apartment building to a bank or real estate partnership will not prevent the co-operative from qualifying as a "co-operative housing corporation," provided that 80% of its gross income is derived from tenant-stockholders who are individuals. *Rev. Rul.* 58-421.

No decedent-income in cash basis farmer's inventory at death; IRS limits Linde rule. Though the *Linde* case (213 F.2d 1, *cert. den.* 348 US 871) concerned a cash basis farmer who had turned over his grapes to a marketing co-operative, some of the language of the opinion was thought by many to imply that, upon the sale of the inventory of a cash basis farmer after his death, the proceeds might be income in respect of a decedent in the hands of whoever received it. The IRS now rules the *Linde* case is not applicable to property, pointing out that in *Linde* the decedent had only a claim for income against the co-operative. *Rev. Rul.* 58-436.

Capital gain on sale of pelts from mink breeding herd. Taxpayers were mink ranchers who would select culls from their breeding herd, kill them and sell their pelts. The court rejects the Government's contention that the mink had been converted from property used in the business to property held primarily for sale to customers. The Government had argued that, if the culled mink were sold alive (as is done with livestock), capital gain would be allowable. However, the court points out that there is no market for live mink of this quality and the only way of disposing of culls was to kill them and sell their pelts. The mere use of ordinary methods does not convert breeding herd into inventory. *Rev. Rul.* 57-548, which holds contrary, penalizes sound business practice and is inconsistent with the purposes of the Congress in enacting Sec. 117(j). *Cook*, DC Minn., 8/22/58.

Capital gain on timber sold by loggers to owner of land. Taxpayers entered into a contract to remove all the timber on a tract of land. They were to pay at a fixed schedule for these stumpage rights. Even though they had the option to sell the logs to others, in practice, the logs were always sold to the owner of the land at current market prices, as stipulated in the contract. The court holds that this arrangement was not a logging service, but a sale which gave the taxpayers title to the logs. Therefore, taxpayers are entitled to treat their income from the cutting of the timber as a long-term capital gain under Section 117(k), 1939 IRC. *Johnson*, CA-9, 7/7/58.

Sewer pipe first clay product. Taxpayer mined fire clay and shale and processed them into vitrified sewer pipe. The Court holds that the pipe was the first commercially marketable product of the mining and that the processing of the clay and shale was the ordinary treatment process for such minerals. Percentage depletion is therefore computed on the sales of the vitrified sewer pipe. *Cannelton Sewer Pipe Co.*, DC Ind., 6/25/58.

Drastic tax effect likely from rise in education costs

COST OF PUBLIC SCHOOL education will double in the next 12 years, reports Roger A. Freeman. If this gigantic rise in public spending is financed by increased taxation, as seems likely, the amounts involved are about like this: increase Federal personal income taxes by 20%, or add another 3% to existing sales taxes, or double present state personal and corporate income taxes, or increase property taxes by two-thirds.

This prediction is made by Mr. Freeman, former governmental adviser on school financing and now vice-president of the Institute for Social Science Research, in his new book, "School Needs in the Decade Ahead."*

Education, Mr. Freeman points out, is now second only to national defense as an item of Government expenditure. In 1958 $20.4 billion, representing 5.75% of the national income, was spent on schools, as against 1.4% in 1890. No other country, not even the Soviet Union, whose educational program has so frequently been compared with that of the U. S. in recent months, spends as much money on schools.

The increase in education costs, however, is not in proportion to the increase in enrollment. If this were the case, no tax boost would be required to take care of it, since the larger number of children would be offset by a corresponding increase in national wealth resulting in greater revenue at prevailing tax rates.

However, only ¼ of the increase in school costs during the past 25 years has been due to larger enrollments and higher prices. Instead, costs *per pupil* have doubled every 20 years since 1900. For example, there has been a radical increase in building costs, which Mr. Freeman attributes to the fact that, 30 years ago, about half the present building space per pupil was allowed. ☆

*"School Needs in the Decade Ahead," by Roger A. Freeman, Washington, D. C., The Institute for Social Science Research, 1958, 273 pp.

TAX ASPECTS OF
Insurance

EDITED BY MORRIS R. FRIEDMAN, LL.M., AND ALLAN A. BAKST, LL.B.

IRS drops proposal to include insurance in estate tax value of redeemed stock

WHEN A CORPORATION uses the proceeds of insurance on a stockholder's life to redeem his stock, does the estate-tax value of the stock based on the value of the corporate assets include the insurance? The proposed estate tax Regulations took the position that, in certain circumstances, the insurance must be included. Now that the final Regulations have come out without this provision, tax men are breathing a sigh of relief.

Section 20.2042-1(c)(6) of the proposed Regulations sets forth a new position by the IRS concerning (1) the role of insurance in determining whether a buy-sell agreement is supported by full and adequate consideration, (2) the valuation of the partnership interest or corporate stock in the decedent's estate and (3) the estate taxability of insurance used to fund the obligations under the agreement.

Adequate consideration

The proposed Regulation provided that, if a buy-sell agreement is a binding agreement for full and adequate consideration in money or money's worth entered into in good faith and at arm's length, the value of the interest or stock set forth by the agreement, and not the value of the insurance, is to be included in the decedent's gross estate. However, where the insurance used to fund the agreement is owned by or payable to the partnership or corporation, then the insurance proceeds are to be considered an asset of the partnership or corporation for the purposes of, first, determining whether the agreement is supported by full and adequate consideration and, second, determining the value of the decedent's interest or shares if the agreement is not considered to have been entered into in good faith and at arm's length.

It has long been settled that, in general, if the buy-sell agreement restricts the transfer of the stock or partnership interest during lifetime, then the price, set for transfer at death, will be accepted for estate-tax valuation. Of course, if the partners or shareholders are related, it becomes questionable whether the prices set in their buy-sell arrangement will be binding for estate-tax valuation purposes.

When the contracting parties are related, there may obviously be some incentive to establish a low value in order to reduce the estate taxes eventually imposed on these interests. In addition, the possibility that a restrictive buy-sell agreement has been employed to effect testamentary transfers by the deceased to the natural objects of his bounty is always present.

The proposed Regulations would have added a new test for determining whether the consideration for an insured buy-sell agreement was full and adequate: Were the insurance proceeds treated as assets of the company in setting the price payable under the agreement for the stock redeemed?

The courts have not deemed it necessary that partners or stockholders consider insurance proceeds an asset of the partnership or corporation in fixing the price of the interest sold. With the dropping of this proposal in the final Regulations, it may be presumed that parties to buy-sell agreements may proceed as they most commonly have in the past; they may value the interest to be redeemed without regard to the insurance proceeds.

This rule was apparently not even limited to controlled corporations. Thus, where an agreement between a minority stockholder and a corporation would otherwise have been presumed to be for full and adequate consideration, the ownership of insurance by the corporation to fund its liability would apparently have defeated any presumption of arm's length dealings unless the proceeds were considered an asset in fixing the consideration.

What exactly would have been the effect of the proposed rule? Ordinarily, a corporation seeking to fund its obligation under a stock redemption agreement would not be inclined to consider that the very existence of the fund, between the time of death and the time of stock redemption, would automatically increase the value of the stock to be redeemed and, of course, automatically increase its liability. If further insurance were purchased by the corporation to cover this bootstrap effect, the decedent's estate, not the corporation, would benefit.

For example, if the stock redemption agreement in a corporation with two equal stockholders called for the redemption prices to be book value, a book value of $200,000 would ordinarily require $100,000 of insurance on each stockholder. The collection and payment of the proceeds on the death of one stockholder would leave the corporation with its net worth of $200,000 intact. If the proceeds were to be included in book value, the corporate net worth after the death of one stockholder would be $300,000, and the value of the deceased stockholder's interest, $150,000. This would leave the corporation shy $50,000. If the corporation obtained insurance of a total face amount of $400,000, then, on the death of one stockholder, the total net worth, including insurance proceeds, would be $400,000; the decedent's interest would be worth $200,000, which would be paid to his estate, and the corporation would again be worth $200,000. (For purposes of this computation, the cash surrender value of the policy on the life of the surviving stockholder has been ignored.)

The effect of carrying the increased insurance would be that the stock would be valued at $200,000 in the estate (compared to its $100,000 value just before the stockholder's death) and the decedent's estate would collect $200,000 instead of $100,000 (the excess being used in part to pay the increased estate tax). The Commissioner and the estate would both be enriched.

Other provisions

Further, Section 20.2031-3 of both the proposed and the final Regulations provides for special attention to be given to determining an adequate value of the goodwill of the business in all cases in which the decedent has not agreed, for

an adequate and full consideration in money or money's worth, that his interest passes at his death to his surviving partner or partners.

Finally, the proposed Regulation, in addition to requiring the inclusion in the decedent's gross estate of the value of the business interest without regard to the agreement, would have included the insurance proceeds also, "if otherwise includible." This would have necessitated determining whether the decedent had retained incidents of ownership in the policy.

The proposed Regulation caused much perplexity among practitioners. In the opinion of the authors, its removal should not compound the confusion, but should merely be cause for a huge sigh of relief. ☆

New estate tax & gift tax decisions

Alternative valuation of inventory of cash basis farmer. When property is valued for estate tax purposes one year after death, income earned in the meantime is excluded. In the case here ruled upon, the executor for a cash basis farmer sold crops and cattle within the year after death and elected to value the estate as of one year after death (or earlier sale). The property sold is includible in the estate at the sales price because no part of the increase in value is "income" and excludible. The income tax basis is this same value and, as a result, there is no gain on the sale by the executor. *Rev. Rul.*, 58-436.

Gifts at 93 not in contemplation of death. Taxpayer had a coronary thrombosis in 1950 from which he recovered. Cancer was diagnosed in late 1952 and he died early the next year, at the age of 94. However, gifts made in 1952, prior to the discovery of the cancer, are held not to be in contemplation of death. Taxpayer had for years made gifts of income-producing property to his children and this was merely another, prompted, like them, by the "life associated" motive of reducing family income tax. *Harrison*, TCM 1958-157.

Check with return "pays tax" though assessment is later. Taxpayer estate filed its return with a check for the amount due, and the formal assessment list was signed about a week later by the Commissioner. Claim for refund was filed more than three years after the filing date, but less than three years after the assessment date. Taxpayer argued the claim was timely because the payment was not of tax until the assessment was made. The court held the payment was of tax and the claim was too late. While there have been cases holding that cash payments were mere deposits, this check was no mere payment into a suspense account to take care of possible contingencies. It was the exact amount of the tax shown on the return accompanying it. *Hill*, DC N. J., 8/21/58.

Property previously taxed reduced by prior estate tax. At issue here is the computation of the deduction, under the 1939 Code, for property previously taxed, specifically, whether the property is reduced by the estate tax paid on the prior estate. This court notes that the issue has been much litigated and courts have held both ways. Since its circuit has not yet passed on the question, it determines that it will follow those cases holding that a deduction is allowable for the net estate only. [The 1954 Code provides a new credit for property previously taxed.—*Ed.*] Nor can this second estate claim the estate tax on the first estate (it paid it) as a deduction. The assets of the first estate were ample to meet it and it was not an obligation of the second. *Morris Estate (Provident Tr. Co., Ex.)*, DC Penna., 7/17/58.

Widow's share, determined in state court, fixes marital deduction. The Government's argument, stated quite briefly by the court, seems to have been that it was not bound by the adjudication of the state court that the widow's share is not reduced by Federal estate tax. Apparently it so reduced the marital deduction on the ground that the state court decision is not binding for the computation of tax. This court holds it is—marital deduction of the full amount due the widow must be allowed. *Morris Estate, (Provident Trust, Ex.)*, DC Penna., 7/17/58.

Estate tax returns prepared by firm should be signed by firm name. *Rev. Rul.* 55-149 had held that, when income tax returns are prepared by a firm, the firm name should be signed to them. If the firm name is stamped or typed, the signature of the person so authorized should follow. This ruling is now applied to estate tax. *Rev. Rul.* 58-396.

Estate does not include stock dividends or earnings after gift in contemplation of death. Taxpayer made gifts of stock in contemplation of death. Thereafter the company distributed stock dividends. The Tax Court had required the valuation of the shares in the estate to include these dividends on the ground that they represented part of the assets of the business at the time of the gift. This court reverses. In fact, the dividends represented earnings after the gift and they can not be assets at the date of the gift. *McGehee*, CA-5, 8/18/58.

Widow's interest in stock not terminable; she could sell it. The decedent had left certain stock to his wife, but added that, if she decided to sell the shares, his nephew should be given the first right to purchase them. Furthermore, if she should die without selling them, they were to go to the nephew. The court holds that the widow's interest in the stock was not terminable; it was not a life estate; she could sell the stock. It therefore qualifies for the marital deduction. *Newton*, DC Okla., 7/22/58.

Jury values stock at option price. Decedent's estate included the stock of two companies. Prior to his death he had given an unrelated person the option to buy the shares of one within three months of his death at $14.57 a share. The option was exercised, and this was the value the estate put on the shares. The Government valued them at $42.00. The jury found the value to be $14.57. The other stock was valued by the estate at $35.00 and by the Government at $41.14. The jury found $35.00. *Conger Estate (Mich. Trust, Ex.)*, DC Mich., 8/25/58.

Interest was life estate with power of disposition; no marital deduction. Decedent's will left her property to her husband, in fee simple, but added that, if any remained at his death, it should go to named beneficiaries. The court examines Florida law and concludes that this is a life estate with power of disposition. The court notes the cases deciding similar issues in favor of the Commissioner and concludes that taxpayer here did not show that it was entitled to a marital deduction for an interest of this kind. *McGehee*, CA-5, 8/18/58.

TAX STRATEGY, NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B., CPA

Program of state-Federal exchange of tax data now beyond experimental stage

A REVISED APPROACH to the handling of the exchange of tax-enforcement information between the several states and the Federal Government has grown out of the five-state pilot program initiated in 1950. O. Gordon Delk, Jr., Deputy Commissioner of Internal Revenue, reported on the results of the pilot program at the Annual Conference of the National Association of Tax Administrators in Coronado, California, recently.

He indicated that the IRS was prepared to enter into agreements for the exchange of tax information with any state which was in a position to hold up its own end of such an agreement.

"We have been attempting for some time to find an economical method for advising state tax departments in regard to the tax adjustments we have made in the auditing of returns," Mr. Delk said. "Reports that serve this one purpose alone can be prepared only at high cost, and we are searching for less costly by-product reports. To date, I must confess, we have not been successful in devising a truly economical 'peel-off' from our operations which is suitable for passing along to the states. Without promising anything definite, I am hopeful that our new research work can find an answer to this problem, as well as to many of our purely internal demands for more economical operations."

The research work to which Mr. Delk referred involves a new IRS program for the application of electronic data processing to the work of the Service. "To this end," he said, "we are installing a new Planning and Research organization, headed by a separate Assistant Commissioner, to conduct all necessary experimental and developmental work prior to the installation of new systems." Mr. Delk anticipates that this research organization will touch the area of state-Federal co-operation in two ways: (1) increased co-ordination of Federal and state activities in the field of tax administration, and (2) the improved methods will be freely available to the states for adaptation to their individual needs.

Mr. Delk pointed out that co-ordination of tax administration is a relatively new development which arose out of the "great expansion in the revenue needs of all levels of government," resulting in "increasing Federal and state reliance upon identical tax sources, primarly the income tax."

"It was just 20 years ago," Mr. Delk said, "that Congress specifically provided for disclosure to the states of information on Federal income tax returns. By that time, some form of income tax had been introduced into the fiscal systems of more than 30 states. The Act of May 28, 1938, authorized the inspection of Federal returns by designated officials of a state, pursuant to the request of its governor, but solely for purposes of administration of the tax laws of the state.

"The provisions of that Act have been incorporated into the Code—Section 6103(b) of the 1954 Code—and constitute the general authority under which the Service has developed its exchange information program with the states."

Up until 1950 this was strictly a one-sided arrangement in which the states received copies of income tax returns and the IRS received nothing. A pilot program of exchange of audit information between the IRS and a small number of states was initiated in 1950 as a result of the General Conference on Fiscal Co-ordination held in Washington in 1949. Five states—Wisconsin, North Carolina, Montana, Kentucky and Colorado—were included in the test program. Other states which asked to participate were told that, for testing purposes, the program would be limited to those five states and not expanded until the test period was over and the results had been evaluated. This, however, did not appear to dampen the interest of non-participants in tax co-ordination. The report of the President's Commission on Intergovernmental Relations of June 1955 stated:

"Interlevel exchanges of information take place informally almost everywhere. The Commission believes that in many functions more systematic exchanges would be distinctly valuable. Such routines are not less necessary in regulation and taxation than in service fields. States with income tax laws have been helped by information from the Internal Revenue Service. Where laws exist to be enforced on one level or aonther, it is especially important that the flow of information be quick and comprehensive." In response to the feeling of the Commission that tax co-ordination should be expanded and to its recommendation for a presidential staff assistant on intergovernmental relations, the president created such a position and appointed former Governor Pyle to fill it.

Meanwhile, the IRS had completed its pilot program and learned that the five "participating states were in general well satisfied with the program," which had resulted in the collection of substantial amounts of additional taxes by the states. The IRS, however, had found the program unsatisfactory on three counts:

"1. The preparation of special abstracts for transmission to the states, on a case-by-case basis, is a high cost operation which weighs heavily on the budgets of our district offices.

"2. With the exception of one state [not named by Mr. Delk—*Ed.*], the exchange of information was markedly one-sided. Elsewhere the enforcement information received from the states left something to be desired, both quantitatively and qualitatively, and hence did not yield much additional Federal tax.

"3. The original agreements were so narrow in concept that they were not readily adjustable to take advantage of special circumstances or opportunities existing in particular states."

While stressing that the IRS was not insisting on a strict quid pro quo basis, Mr. Delk stated that the service did feel that a completely one-sided arrangement was undesirable. Accordingly, a recasting of the program was undertaken with three objectives in view:

"1. To tailor each agreement to the administrative situation prevailing in a particular state. Such factors as the laws

of the state, the pattern of its tax system, the scope and strength of its enforcement efforts, and the possibilities for effective meshing of Federal and state audit activities should be considered. . . .

"2. To maximize the total . . . aggregate benefits to both the Federal and the state governments. One important step in that direction is to broaden the scope of information exchange beyond the income tax return. Both the states and the Federal Government now informally seek information relevant to the administration of other taxes, and it seems desirable to regularize such exchanges by extending the program to cover excise, estate and gift taxes. It is possible, for example, that a state may have much useful information on motor fuel and transportation taxes, but only very little on income taxes, and that our District Director may be in a reverse posture. If so, a swapping of information will be mutually advantageous. Other areas that may hold some promise of additional benefits include the division of territory for concentration of audit work, and co-operative efforts in canvassing for non-filing of returns. . . .

"3. To attain a better balance between the benefits received and the costs incurred by the IRS."

Mr. Delk expressed the belief that every state would like to co-operate to the fullest extent with the IRS, but that the enforcement system in some states was not adequate to obtain the necessary data. He expressed willingness on the part of the Service to help any state with its enforcement system "without any flavor of Federal interference in the fiscal affairs of the state. A look to the future, however, suggests that further expansion of these joint programs depends to a large extent on what state tax administrators are able to do in the development of their own audit programs. This conclusion holds both for extension of coverage to additional states and for intensification of programs within states already covered."

Meanwhile, Minnesota has entered the program under an agreement based on the new approach and a revised agreement with Wisconsin was ratified in May, 1958. The IRS holds itself out as prepared to go along with expansion of the program in the light of its new objectives and the increased efficiency in return-processing promised by the Planning and Research work. ☆

Federal tax liens anarchic – ABA group proposes Federal statute

LAWYERS ARE SO INCENSED over the trend of cases in recent years giving Federal tax liens priority over security interests that would have been preferred under law that, according to the ABA Committee on Tax Liens and Collection Proceedings, the House of Delegates would undoubtedly pass a resolution to support sweeping legislation making the status of Federal tax liens a matter of the state law involved. However, the Committee continued, the opposition of the Treasury to any such legislation would be so strong that Congress would be unlikely to adopt it. The ABA Committee has therefore begun a detailed study of security interests affected by Federal tax liens and proposed legislation specifying the status of many such claims.

The Committee report used strong language in describing the current status of Federal tax liens. "If those who make the Government's litigation policy in tax collection cases were consciously seeking to invite legislation drastically curtailing, and perhaps crippling, the Federal tax lien, they could find no better way to do it than to take the legal positions which [they have.] . . . It is not surprising that many lawyers have reacted by advocating making Federal tax priorities subject to the rules of state law. The states at least do have rules, while Federal law on this subject is an anarchy, providing few restraints, because Congress has never addressed itself to the policy questions involved.

"This Committee, recognizing that the Government's success has irritated a large segment of the Bar, rendering it difficult to take the middle ground, nevertheless believes that the policy choices must be made by Congress, and not delegated to the states. We further believe that a recommendation to Congress of the 'state law' approach will be futile" says the Committee, "because of strong Treasury opposition, and can serve only to delay needed relief. Accordingly, we have sought to frame proposed legislation which will recognize all cases where relief equitably should be afforded, but subject to such restrictions and accommodations as will prevent impairment of the legitimate tax collection process.

"The first fruits of our efforts are found below. It should not be considered, however, that this is the full extent of the relief which we feel should equitably be granted. This is simply the 'crash program,' the legislation which ought to be enacted with the least possible delay, while time is taken to ascertain how much further we should go. Among the many issues on which no recommendation is made at this time is to what extent, if at all, the priority of landlords' liens should be recognized as against the Federal tax lien, and whether any modification should be made in the rule of the *Flood* case, by which maritime liens outrank even prior tax liens. We shall consider also whether certain other liens, reflecting benefits conferred upon or improvements to property under circumstances in which a title search would often be impracticable, should be preferred even over previously filed tax liens e.g., liens of repairmen, carriers, warehousemen, and the owner of breeding animals).

"By express enumeration, it is possible to prescribe the priority status of many of the commoner types of liens. But there are a great many statutory liens which are peculiar to particular states, and which may defy classification. The Association, in its studies of the Bankruptcy Act, has found that not all statutory liens are equally deserving of recognition. The States themselves have frequently not considered such liens deserving of priority as against the 'imperious need' for revenue, and have preferred their own tax liens over even pre-existing liens. Much more study may be needed before any general formula for the priority of unenumerated liens can be developed.

"There remains also before us the problem of applying similar principles with respect to the special liens for estate, gift and distilled spirits taxes."

In its general explanation of the specific rules that it proposes, the Committee on Federal Tax liens and Collection Proceedings briefly summarized the present status of the law and the changes that it would make.

"The Federal tax lien," the Committee said, "attaching to all property 'belonging to' the taxpayer, arises as a secret lien at the time a tax is assessed.

(IRC Sections 6321-6322.) As against mortgagees, pledgees, purchasers and judgment creditors, the lien is valid only when notice thereof is filed in the prescribed office. (Section 6323.) Although the Supreme Court has declared the controlling rule to be that 'the first in time is the first in right' (*City of New Britain,* 347 U.S. 81 (1954)), it would appear that the court has virtually nullified that principle in a series of decisions holding that the competing lien must be 'choate,' by which it means, not only that such lien must attach to specific property, but that its amount must be fixed beyond controversy, usually by judgment.

"Accordingly, in *White Bear Brewing Co.,* 350 U.S. 1010 (1956), the Court subordinated a mechanic's lienor who had completed the work, filed his lien and commenced foreclosure before the Federal tax lien arose. In 1957, the Association recommended legislation to avoid the effect of that decision, and to prefer mechanics' liens or similar claims on real or personal property or the proceeds of a contract, if they arise under state law before the Federal tax lien is filed, and if they are duly maintained as effective liens under state law. Exceptions were provided with respect to liens for unpaid withholding and employment taxes on the very project, and also to prevent other liens from gaining an advantage through the operation of 'circular priority.' Such recommendation is renewed as part of the present proposal, with modifications to clarify the definition of 'mechanic's lienor' and to refine upon the 'circular priority' exception. The surety who satisfies the claim of one who would otherwise be entitled to a mechanic's lien is given similar protection.

"The Supreme Court's decision in *R. F. Ball Construction Co.,* 355 U.S. 587 (1958), extends even to contractual liens, in the nature of mortgages or pledges, the requirement that they must be 'choate' in order to be valid against the Federal tax lien. Apparently any security for a future or contingent obligation—indemnity for a surety or endorser, security for future rent, or a mortgage to secure even obligatory future advances—will be subordinated under that principle." The legislation it proposes, the Committee said, "would, in general, assure the holder of a mortgage or other security of the priority provided by state law, in the case of security for obligatory advances and those (even if technically optional) made to continue or complete the financing of a contract or construction project, or of a crop, livestock or the production of inventory. In the case of most arrangements for security for optional advances, however, even though priority under state law may date from recording of the instrument, priority over intervening Federal tax liens is proposed to be conditioned upon notifying the District Director of the arrangement. Since it is impractical for the Director to search the title to property when he files a tax lien, he could not, unless given such express notice, prevent the dissipation of the security of the tax lien through further loans, having priority against the liened property.

"The Federal tax lien attaches automatically to after-acquired property of the taxpayer. In some states, a mortgage or factor's lien, or the like, can do likewise; but not as against an intervening Federal tax lien. It is recommended that the priority of such security be recognized, subject to reasonable safeguards.

"The proposed legislation would make clear that contract purchasers are entitled to the protection which 'purchasers' enjoy against unfiled Federal tax liens. This would overrule a decision which deprived installment purchasers of both the property and their payments when Federal liens arose subsequently.

"Certain liens are proposed to be preferred even to Federal tax liens previously filed against the taxpayer. The first of these is purchase-money security, including vendor's liens. The second is the lien of an attorney upon a cause of action, since without his efforts there might be no proceeds from which the tax lien could be satisfied. The lien which a number of states grant to hospitals, doctors, etc., upon a cause of action for personal injury or wrongful death would be similarly preferred.

"It is also proposed that liens for real property taxes and special assessments, regardless of their date, be preferred over the Federal tax lien. This is on the same principle that property acquired by the United States upon foreclosure of insured mortgages is not subjected, by consent of Congress, to property taxation. (12 USC Section 1714.) However, when a property tax arises after the tax lien, consent would be given only that the Federal tax lien bear its *pro rata* share of the tax on the entire property.

"'Other state and local tax liens would take priority from the time they are assessed or otherwise determined and become liens." ☆

IRS announces Supplement to Cumulative Bulletins

THE IRS has announced the availability of Publication No. 401, entitled Index-Digest Supplement to Cumulative Bulletins 1953-1956, which indexes and summarizes all the material which has appeared in the Cumulative Bulletins for those years. The Supplement consists of four parts: a finding list for all public laws dealing with internal revenue, an alphabetic listing of all tax cases with capsule summary and reference to the Bulletin in which it can be found in its entirety, a topically indexed digest of everything reported in the Bulletins, and a key to the index system used.

Primarily intended as a research tool for Service people, the index is available to the public and may be ordered from the Superintendent of Documents, Washington 25, D. C. at $2.25 a copy. ☆

IRS did record business in 1956; $33 billion collected

MORE PEOPLE paid more tax on more income in 1956 than ever before in our history, Commissioner Harrington announced recently. The staggering statistics are: 59.2 million individual returns, of which over 46 million showed income tax liability, reported a taxable income of $141.5 billion on which taxes of $32.7 billion were paid. That is some 900,000 more returns than were filed in 1955; income was $13.5 billion more, and taxes were $3.1 billion more. Adjusted gross income was almost $268 billion, of which salaries and wages accounted for $216 billion. ☆

IRS testing electronic devices for return auditing

THE IRS is now experimenting with the use of electronic devices to select returns for auditing and to analyze the returns of an entire industry as a basis for further auditing. The Commissioner reported these developments at a recent meeting of the Pennsylvania Institute of CPAs. He said that the idea is being tested under a broad program designed to learn how electronics can help the IRS meet its ever-increasing workloads.

"Heretofore, we have had to make a manual selection of returns for audit,"

he said. "Under our electric experiment, we are trying to take advantage of mass production techniques to do the job faster, more accurately and, we hope, at less cost."

Another possibility under study, Mr. Harrington said, is the use of electronics to analyze the tax returns of entire industries, with each industry considered as a separate audit unit.

The industry study, he said, may achieve two ends—one, identifying more accurately and economically the categories of returns most likely to be in error and, two, helping industries improve the reporting on their returns.

The industry study still is in the blueprint stage, he said, but the individual program is further advanced. ☆

IRS is publishing more rulings currently

A TOTAL of 40,157 requests for tax rulings and technical advice was processed in the National Office of the IRS during the year ended June 30, 1957, the IRS reports. Of these requests, 30,874 related to income and excess profits taxes. The requests included 35,672 from taxpayers and 4,485 from field offices of the Revenue Service. In addition, 16,515 technical conferences with taxpayers and their representatives were held on these and related matters.

"An analysis of the cases processed, by subject matter, is as follows:

Subject	*Total*	*Taxpayers' requests*	*Field requests*
Total	40,157	35,672	4,485
Income and excess profits taxes	30,874	29,623	1,251
Employment and self-employment taxes	1,831	1,360	471
Estate and gift taxes	912	717	195
Alcohol & tobacco taxes	2,328	842	1,486
Other excise taxes	3,430	2,560	870
Engineering questions (depreciation, etc.)	782	570	212

"During the year, there was a 10% increase in the number of Revenue Rulings and Revenue Procedures published in the Internal Revenue Bulletin. Most significant was the 78% increase in the number of excise tax rulings published—from 116 in fiscal 1956 to 207." ☆

Jenkins-Keogh Bill killed in committee

THE HOTLY DISPUTED "Self-Employed Individuals' Retirement Act," also known as the Jenkins-Keogh Bill, died in the Senate Finance Committee. The measure, which permitted tax-free accumulation of retirement funds for self-employed, and would have resulted in an estimated $365 million a year loss of revenue, was opposed by the Treasury Department, although it was praised in other quarters as providing a more equitable set-up for persons not eligible for organization pension plans.

The House passed the bill on July 29, after holding it for 18 months in the Ways and Means Committee. The bill thus reached the Senate Finance Committee almost at adjournment time and when hearings on other matters were already scheduled. Senator Byrd, chairman of the committee, felt that so controversial a measure should not be reported out without public hearings and so self-employed persons will at least have to wait until next year for the relief they had anticipated. ☆

New procedural decisions this month

Collection enjoined; notice was incorrectly addressed. Under the Code, assessment of tax is valid only if a proper notice of deficiency is given. Here the Commissioner by error sent the registered deficiency letter not to the last known address of taxpayer, but to the new address of a firm with which he had once shared space. His incorrectly addressed deficiency notice is held not valid, and the court enjoins the collection of the taxes so assessed. *Moore,* DC Ohio, 8/1/58.

Estimated tax payments paid for statute of limitations purposes when return is filed. Taxpayer made claim for refund within three years of the filing of his final return. However, more than three had elapsed since he had made his estimated tax payments for the year. The Commissioner limited the refund to the payment that accompanied the final return. The court allows refund of the estimated tax payments. The payments on the estimate were not payments of tax but only credits against the taxpayer's estimated future liability. Payment of tax occurred when the return was filed. The credits were then applied. The Code provision that advance payments of tax are to be considered as paid on the last day for the filing of the return without regard to any extension of time granted taxpayer covers payments accompanying returns that are made prior to the statutory due date, but does not deal with estimated tax payments. *Plankinton,* DC Wisc., 8/19/58.

Levy enjoined pending statutory assessment. After remand to the Tax Court from the court of appeals, taxpayer stipulated to certain deficiencies. The District Director attempted to levy on certain purported liens entered while the matter was pending, in satisfaction of these deficiencies. No statutory assessment having been issued in respect of the Tax Court stipulation, the court enjoins the Director from levying on these purported liens. *Gunn,* DC Ark., 8/11/58.

New question, another year, cannot be received in Tax Court. Taxpayer in a Tax Court proceeding challenged the Commissioner's assessment of transferee liability against her for her husband's taxes. While she admitted that she received $68,000 from her husband while he was insolvent, she claimed that it was her share of the community property. The Tax Court held her liable, but the circuit court reversed. Thereafter the Commissioner reversed certain overpayment credits on her own income tax on the ground that these overpayments were community property and as such were subject to the income tax liability of the husband. Taxpayer attempted to challenge this by a motion in the Tax Court proceedings. The Tax Court denied the motion on the ground that its jurisdiction was limited to carrying out the mandate of the circuit court in reversing. This court now affirms. *Santos,* CA-9, 8/8/58.

District court lacks jurisdiction in husband-wife settlement controversy. In a previous action, taxpayer was awarded judgment for a tax refund of $138,000. Subsequently he and his wife were divorced. The settlement agreement provided that he would pay any of her tax deficiencies and that she would cooperate with him in certain matters. The Government paid $83,000 of the judgment, but withheld $55,000, which it credited against the wife's deficiencies. Taxpayer now brings this action against both his ex-wife and the Government to recover the $55,000, alleging that she has failed to perform her part of the settlement agreement. The court dismisses the action. The Judicial Code affords no basis for jurisdiction in this type of case. *Karpe,* DC Calif., 8/1/58.

INCOME TAXATION OF
Trust & estates

Multiple trusts: apparent or real loophole; is any remedy feasible?

TAX MEN HAVE BEEN SAYING that the only reality about the "multiple trusts loophole" is the undoubted theoretical possibility of huge tax savings *if* the practical difficulties are ignored. Practical tax men responsible for advising actual and prospective donors and trustees watch with some misgivings the developing sentiment for some legislation in this field, since the announcement in 1956 that legislation on this topic would be submitted to Congress. They fear extremely complicated legislation that may become a trap for the unwary. Last summer (7 JTAX 88) we reported on the plan proposed by the Advisory Group of practitioners appointed by the Mills subcommittee on Internal Revenue Taxation. Their plan was to tax as one trust essentially similar ones created by the same donor. The Committee on Income of Estates and Trusts of the ABA Taxation Section studied the Advisory Group's proposal and made a similar recommendation for legislation. However, at Los Angeles the council of the Section voted against the recommendation, as did the members of the Section voting from the floor.

ABA Committee comments

Although the Committee on Income of Estates and Trusts finally decided to recommend legislation similar to that proposed by the Mills Group, it had earlier prepared a report of its comments on the Mills Group proposals, which, though the Committee insisted they intended to be helpful, not critical, seemed to indicate that the committee was not sympathetic to the Mills Group proposals.

The Taxation Section Committee termed "inadequate" the Advisory Group's discussion of the reasons for proposing multiple trust legislation. "There is reference," the Committee continues, "to 'sporadic concern ever since the hearings on the Revenue Act of 1937' about the tax avoidance possibilities of accumulating income in multiple trusts, and to the fact that the throwback rule is not very effective because of its $2,000 per trust exemption. The report leaves one uninformed about the amount of tax avoidance that is now being practiced by the use of multiple trusts or that could be anticipated either in terms of the revenue involved or the number of taxpayers."

The Committee said that it did not "have enough information to pass judgment on the importance of the multiple trust problem. The tax avoidance opportunity is apparent, at least with respect to currently accumulated income, but knowledge of the extent to which the opportunity has been or would be used and of the tax effects thereof is not available.

"If the desirability, the necessity, or, as some have expressed it, the inevitability, of multiple trust legislation be assumed," the Committee continued, "[its] view is that the Advisory Group has made a fine effort." The Committee said that its comments on that effort are general in character and are related to (1) the Advisory Group's interpretation of the circumstances under which the primary beneficiaries of two or more trusts are deemed to be substantially the same, (2) the situations excepted from the operation of the statute and (3) a suggestion about confining the statute to income currently accumulated. These comments can hardly be called criticisms in view of the complete absence of experience with the administration of such a statute.

Under the Mills Group proposals, the Committee said, "the major problem of defining the trusts that would be subject to the proposed multiple trust rules is resolved with an objective test, namely when there have been established by the same grantor separate trusts having primary beneficiaries who are substantially the same. There will be some members of the tax bar who will prefer a test containing subjective elements relating to the presence of an intent or purpose to avoid taxes through the creation or use of multiple trusts." The Committee approved of the objective test approach adopted by the Advisory Group, and in so doing, it said that it thought it reflected the view of the majority of lawyers who will give thought to the matter.

"For the protection of the fiduciary against personal liability for taxes arising out of facts unknown to him, the Advisory Group proposes to limit such liability to cases in which the fiduciary has actual knowledge. And except where a trustee is acting for two or more of the trusts proposed to be consolidated, he is not to be charged with knowledge of liability for taxes under the multiple trust section until he has received notice thereof from the Commissioner. A corporate fiduciary is not charged with knowledge of facts coming into its possession through business other than trust administration." These rules seemed to the Committee to afford adequate protection to fiduciaries.

"The Advisory Group," the Committee said, "has set forth certain principles for determining when the primary beneficiaries of multiple trusts are substantially the same and has illustrated the principles with a number of examples." However, it continued, "Some of the examples appear to do violence to what could be expected from the application of the rules laid down in the text of the report."

The Committee noted that the examples criticized all have to do with cases in which one of the trusts is a marital deduction trust for Federal estate tax purposes. It speculated that the results reached in the examples reflect a special concern for such trusts. If so, it thought that some kind of exception for marital deduction trusts might be in order.

"With respect to both inter vivos and testamentary trusts," the Committee continued, "exceptions from the multiple trust rules are proposed when the accumulated income or the taxable income allocated to corpus, or both, are less than $2,000 and when the consolidated computation produces less taxes than the total taxes would be on a separate

basis." The consensus of the Committee seemed to favor both exceptions, but some members of the Committee, it said, "have strong views against the second one. They feel that a statute purporting to provide objective tests for the taxation of multiple trusts should abide by the tax results whether favorable or unfavorable to the revenue. The Advisory Group has simply said that the second exception is designed to prevent the use of the multiple trust provisions to reduce taxes that would otherwise be payable."

A third exception from the multiple trust rules, applicable only to inter vivos trusts, was somewhat puzzling to the Committee. "It would exempt from the proposed requirement of consolidation not more than two trusts if not created within five years of each other, and not more than three trusts if no two of them were created within five years of each other. Members of the tax bar have had some difficulty in concluding that the language of the proposed statute does no more than what has just been described, but close analysis leads to the belief that the statute is accurately worded. Perhaps some improvement can be made in the text of the report dealing with this provision. The Advisory Group has said that the exception has been created for the case in which a lapse of time has made it undesirable to add property to an existing trust. Why one grantor's trusts should have a tax advantage over those of other grantors because some defects have apparently been found in his original trust instrument is not," in the Committee's opinion, "adequately explained. The assumption may be," it said, "that tax avoidance motives disappear with the passage of time," but it said it felt that it had no basis for determining the truth or falsity of such an assumption. The Committee felt that logic did not support the exception. If there was a good reason for it, the Advisory Group did not appear to have made a satisfactory explanation of it. "The Group's statement that no significant avoidance is possible under the exception does not seem to be demonstrable.

"The proposed statute operates with respect to the separate trusts when they meet the statutory tests by consolidating the currently accumulated income and also the taxable income allocated to corpus. While the tax avoidance possibilities of multiple trusts through accumulation of ordinary income may be clear, the situation in regard to taxable income allocated to corpus may not be so clear. The items involved in the latter class of income are capital gains, taxable stock dividends and extraordinary dividends. The rate on capital gains varies from 10% to a maximum of 25%, depending on amount of gains and other income involved. Multiple trusts present a possibility of savings within that range as to capital gains. Savings of taxes on the other items are possible also, but one would not expect them to occur with regularity. If experience has not shown extensive use of multiple trusts to reduce income taxes in these areas, it might be well to exclude the capital income items from the proposal at least at the beginning of the statutory experiment. Aside from the absence of a showing that the application of the statute to such items is required, the above suggestion is put forward for two reasons. First, some sentiment has appeared reflecting a fear that the statute would work some unfairness, especially as to capital gains. Second, as has been observed earlier, the Advisory Group seems to have had real difficulty, as reflected in some of its examples, with the capital income items when marital deduction trusts are involved.

"If such a reduction in the scope of the statute's application is considered to be too broad, consideration might be given," the Tax Section Committee continued, "to an exemption for marital deduction trusts in respect of taxable income allocated to corpus. Such an exception would embrace revocable inter vivos trusts as well as testamentary trusts of that description. It will be noted that the great bulk of marital deduction trusts provides for the distribution of the income currently to the surviving spouse so that the new multiple trust rules would, for the most part, apply only to income allocated to corpus.

"A better suggestion, perhaps, that would avoid the necessity of defining a marital deduction trust, would be to exempt all testamentary and revocable inter vivos trusts insofar as income allocated to corpus is concerned. Certainly the major tax avoidance opportunities with respect to capital items are in the non-revocable inter vivos trusts."

A final suggestion of the Committee would be to exempt from the multiple trust statute all simple trusts or perhaps trusts all of whose income is required to be distributed. The effect of the latter would be to exempt from the statute trusts which could not accumulate current income and thus would not present the major opportunity for tax avoidance against which the proposed multiple trust provisions are directed. ☆

New trusts & estates decisions

Fiduciary for estate and trust may make separate elections for each. The Code provides that an election to include the increment in value of U. S. Savings Bonds in income in any year is binding for future years. However, an election as executor is not binding on a trustee under the following circumstances: An executor of an estate on the cash basis elected to treat as income the increment in value of U. S. Series E Savings Bonds owned by the estate and not finally matured. Immediately after the close of the taxable year, the executor, pursuant to decedent's will, transferred the bonds to himself as trustee of a trust. The IRS holds that he may, as trustee reporting on the cash basis, elect to report the interest on the bonds in the year they are redeemed or mature. *Rev. Rul.* 58-435.

No gift in adding to trust; chance that another would benefit too remote. In 1924 taxpayer created an irrevocable trust, income to be accumulated. However, the trustees were empowered to pay income to his father if needed. In 1945 he made substantial additions to the trust, which the Commissioner asserted were gifts to the father. The court, noting the father's substantial means, holds that there was little chance he would need it and there was no gift. *Clement,* DC Penna., 9/4/58.

No gift tax on creation of revocable trust. Five related taxpayers created a spendthrift trust, 90% of the income to go to them, the remainder to be accumulated. All the grantors, acting together, can revoke the trust. Since each grantor's share is kept separate, the IRS concludes that no other grantor has an adverse interest in another's share. Consequently, although revocation can be made only in conjunction with others, the others are not persons with an adverse interest. It follows that there is no taxable gift on the creation of the trust. *Rev. Rul.* 58-395.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

What is the prevailing wage in testing suitable employment?

ONE OF THE MORE DIFFICULT areas in the administration of unemployment insurance involves the determination as to when refusal of suitable work should be disqualifying. Various elements might affect such refusal, but generally the most common factor in the refusal of suitable employment is the claimant's feeling or belief that the offered wages are "substantially less favorable than those prevailing for similar work in the locality."

To help its staff in the determination of "what is a prevailing wage," the New York State Department of Employment recently published a bulletin. We believe it is worth presenting their thinking in this area since it can be generally applied in other states. The Department states:

"Whenever the questions of wages becomes an issue, it is important not only to resolve the prevailing wage question, but also to investigate whether the claimant may have good cause to refuse the job for other reasons. Such other reasons may be related to the wages even though these wages satisfy the prevailing wage requirement. Questions which must, therefore, be investigated in all such cases are these:

"1. What is the prevailing wage rate?

"2. Are the offered wages substantially less favorable than that rate?

"3. Does the claimant have other 'good cause.' including reasons related to the wages, to refuse the job?

Prevailing wage concept

"A 'prevailing' (most frequent or predominant) wage exists when a substantial number of workers in an occupation, such as 40% or more, is paid the same rate of wages. There is then a preponderance of workers who are paid that rate. A wage rate so established is called the 'mode.'

"If the wage distribution in an occupation does not show such concentration so that there is no preponderance of workers paid at a single rate, a substitute measure must be found to establish the prevailing rate for unemployment insurance purposes. A straight average or arithmetic mean is unrealistic because it takes no account of the position of workers in the distribution and is heavily influenced by wages at the extreme ends of the distribution. A better approach is to consider the positions of all workers in the classification and to use the wages of the worker in the middle position, the 'middle worker,' as identifying the prevailing rate. A rate so established is called the 'median.' It means that no more than half the workers are receiving less than this rate.

The prevailing wage rate

"On the basis of these considerations, prevailing wages are to be established in this manner:

"*1. Concentration of 40% or more of workers (mode).* If 40% or more of the workers in the entire range of wages for an occupation are paid the same wage rate, then such rate is prevailing.

"*2. The 'middle worker' (median).* If there is no concentration as described above, then the wages paid to the middle worker in an array of the workers in the occupation by wage rates represent the prevailing rate.

"Middle worker"

The 'middle worker' in an array of workers in an occupation by wage rates is identified by a listing of the workers, one after the other, according to their individual wage rates. If several workers receive the same rate, each of them is, nevertheless, entered separately on the list. If there is a sample of, say 101 workers, the 51st worker on that list is the "middle" worker. Of course, the 50th, the 49th, etc., as well as the 52nd, the 53rd, etc., on the list may have the same rate as the 51st worker. If the number of workers in the sample is even, for example 100, and the wages of the 50th and 51st worker are different, the rate of the 'middle worker' is assumed to be the midpoint between these two wage amounts. Expressed more generally, the 'middle worker' is that worker whose wages are not below the wages which 50% of the number of the workers in the occupation receive. . . . *Therefore, when in a wage analysis a 'median' for the entire range of wages in an occupation has been established, that figure represents the rate paid to the 'middle worker' and can be used for identifying the prevailing rate.*

"After having established the prevailing wage rate, it must be determined whether the offered wages are 'substantially less favorable' to the claimant than such rate. The solution of this question is governed by these principles:

"*1. More than 10% below prevailing rate.* Wages are as a rule 'substantially' less favorable than the rate of prevailing wages if their dollar amount is more than 10% below that rate. In addition, the statutory requirement would not be satisfied by wages which are (a) below the *entire* wage range for the occupation or (b) below minimum wages under a state or Federal wage law or wage order.

"*2. Special situations.* There may also be special situations where offered wages must be considered as 'substantially less favorable to the claimant than those prevailing for similar work in the locality' although their amount is not more than 10% below the rate of prevailing wages.

Prevailing wages in unusual cases

"Sometimes it is not feasible to establish prevailing wages by the usual methods because there are no typical or predominant wages for the work in question.

"This may be due to the varied and complex nature of the duties performed and will apply particularly to professional, managerial, unique, or exceptional occupations or to cases where a claimant performs mixed duties none of which is sufficiently controlling so that his job does not lend itself to a recognized occupational classification.

"Since prevailing wages cannot be established in such situations by means of a survey, a judgmental approach is necessary in determining whether offered wages will satisfy the statutory requirement. No rigid principles apply in such cases, and determinations should rest upon a rule of reason. A recent Appeal Board case is an illustration of

this approach. An electronic engineer (without an academic degree) was offered a job in a related field at a starting wage of $115. No comparable wage data were obtainable because of the characteristics of the offered job. In most of his prior jobs, the claimant was paid a salary of $120 per week with very brief periods at $135 to $140 per week. The Board decided that the claimant refused the job offer without good cause and held that 'wages earned by the claimant in previous employments may be some indication of the prevailing rate for a person with his qualifications.'

General "good causes"

"Although offered wages are not substantially less favorable than the prevailing rate, the following must be considered, in addition to other circumstances constituting good cause, in order to meet situations which would otherwise result in undue hardship.

"1. If there is a significant difference between the offered wages and the average weekly wages which claimant earned during his base period, a claimant should as a rule not be disqualified until he has been afforded a reasonable time to find employment at wages nearer to those which he last earned. A period such as two months from the time he was last employed will generally constitute a reasonable time. However, the period may be longer or shorter, depending on the circumstances. No absolute or relative amounts can be given which would represent a 'significant' difference between offered wages and past earnings. A differential of two dollars per week may be significant at the lower wage levels, such as $30, whereas an amount as high as $15 may not be significant in this sense at a $100 wage level.

"2. Other illustrations of possible general 'good cause' for refusing employment, even though offered wages are not substantially below the prevailing rate, include these: A requirement that the claimant purchase expensive tools or supply a car, without suitable allowances for reimbursement provided, when such requirement is not customary.

"3. Sight should not be lost of the fact that refusal of employment by a claimant is with good cause under specific statutory provisions if the 'travel to and from the place of employment involves expense substantially greater than that required in his former employment unless the expense be provided for.'" ☆

All ex-servicemen now get unemployment compensation

PRESIDENT EISENHOWER recently signed into law a bill extending unemployment insurance benefits to servicemen leaving the armed forces. Formerly, only those who served in World War II or in Korea were eligible for Federal benefits under the arrangement which was known as "52-20." Other veterans had to establish a work record prior to becoming eligible for unemployment benefits.

It is estimated that the benefits will cost $70,000,000 annually, and the funds will come directly from the Federal budget. Administration of the law will be in the hands of state unemployment agencies who will subject veterans to the same rules of eligibility as are used for other unemployed workers. Benefits will vary in amount and duration according to state law. The weekly unemployment benefit amount will be based on a wage base including military cash wages and allowances.

This new law, which is known as "The Ex-Servicemen's Unemployment Compensation Act of 1958," makes benefits available for weeks of unemployment ending after October 27, 1958. ☆

Unemployment benefits increased in Louisiana

THE MAXIMUM WEEKLY unemployment benefit in Louisiana has been increased as of July 30, 1958, from $25 to $35; and the minimum from $5 to $10. At the same time the duration of benefits was changed from the lesser of 20 times the weekly benefit amount or 40% of base-period wages to the lesser of 28 times the weekly amount or 40% of base-period wages. Thus maximum benefits payable to an individual will amount to $980 (28 × $35), whereas prior to this change the maximum was only $500 (20 × $25).

An individual not regularly employed may now earn up to $5 a week without any deduction being made from his weekly unemployment benefit. Prior to the change, earnings over $3 weekly meant a reduction of weekly benefits.

Finally the law was amended so that benefits will be paid for the one-week waiting period which was heretofore uncompensated. These extra benefits will be paid provided the unemployed individual remains unemployed for six consecutive weeks or more. ☆

New

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NEW DEVELOPMENTS IN

Tax-exempt institutions

AND RELATED MATTERS

Trade associations warned of tax danger in shows

CURRENTLY THE IRS is cracking down on tax-exempt institutions which expand beyond the limited activities permitted them, and rumors have been abroad of late that it is paying particular attention to trade associations.

The associations take the position that the trade show is "educational" and serves the entire trade or industry; the Service is asserting that it promotes the welfare of the exhibitor as an individual and some comments by the industry itself indicate that the IRS has some ground for its position. For example, a promoter of trade shows is quoted in the September 1958 *Management Review* as suggesting that the exhibitor can evaluate the effectiveness of the show in these terms:

"In a well-organized exhibition, you can count on making something like 40 or 50 contacts a day—about 10 times more productive contacts per day than a salesman can make in the field. If you know the average cost of your salesman's call, than you can compare what it costs 'per call' to participate in an exhibition."

The promoter is further quoted as adding that an even more important consideration is "that the buyer comes to you—and in a receptive frame of mind."

A recent revenue ruling indicates that the Service tends to agree with the promoter in a context where it hurts. *Rev. Rul.* 58-224 denies exempt status to an organization which, as its principal activity, stages an annual merchandise show. The particular organization involved is a non-profit membership corporation consisting of committeemen of the local chamber of commerce who are interested in the sale and distribution of gift and housewares merchandise. No dues are charged and the purpose of the organization is stated to be "to promote the interest of trade and increase the facilities of commercial transactions, particularly in connection with the display, distribution and sale of merchandise." Its only activity was an annual merchandise show sponsored by the chamber of commerce, at which the exhibitors were for the most part manufacturers, together with a few wholesalers whose goods were not included in the manufacturers' exhibits. A buyer's guide describing the exhibits and stressing "the economy and convenience of making all purchases of merchandise under one roof," is distributed free. The show is not open to the public. Retailers may order goods at the show, the income of which is derived from rental of exhibit space and sale of banquet tickets.

According to *Rev. Rul.* 58-224, this organization does not qualify under the definition of a business league, in Section 501(c)(6), since it does not promote business generally, but serves as a convenience to the individual exhibitors in distributing their merchandise. Thus, its earnings inure to the benefit of private individuals and disqualify it.

Even more significant as an indication of the climate of opinion in the IRS is a further warning appended to the ruling which states that the denial of exemption to this organization is not to be interpreted as implying that a similar organization would qualify if it invited the public to its show and sold no merchandise there. "In such event," the ruling concludes, "consideration would be given to the extent, if any, to which the organization is promoting the interests of individuals from the standpoint of its over-all activities."

A trade show in the apparel and shoe field was denied exempt status in language almost identical with that of *Rev. Rul.* 58-224: "In conducting the selling markets, you provide direct advertising campaigns for the distributors and provide, primarily, selling opportunities for them, as well as opportunities for retailers to see all types of merchandise under one roof. Therefore, it is our position that you are rendering particular services for individual persons as distinguished from the improvement of business conditions generally." And, in *Rev. Rul.* 57-52, exempt status was denied a show which did admit the general public and which turned over its profits to the county recreaton board for the operation of public playgrounds.

Although the machinery for riding herd on exempt institutions has existed all along in the unrelated business income provisions (Sections 511-3 of the 1954 Code; Sections 421-2 of the 1939 Code), the tendency of the IRS has until recently been to be quite lenient in the application of these sections. Currently we are witnessing a reversal of this trend, doubtless inspired by the realization of the potential revenue involved, the increasing activities of the exempt organization and the growing clamor of taxpaying businessmen against the competition of exempt institutions. [See 9 JTAX 169.—*Ed.*]

Sections 511-3 provide for the taxation of business leagues, among others, on income from "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501. . . ."

This provides another rationale for the taxation of trade shows, as is indicated in *Rev. Rul.* 57-52, which describes a trade show as "a business which is ordinarily conducted for profit." If an exempt institution regularly carries on an activity which would be considered a business if anyone else carried it on, this constitutes an unrelated trade or business unless the workers receive no money, the work is done solely for the convenience of the personnel of the organization, or the activity consists of the sale of donated merchandise.

It may be claimed that the show qualifies as an educational activity, but this, too, is risky since the improvement of products, the enhancement of the efficiency of persons and the improvement of the condition of individuals in a particular line of work are taken to deprive the exhibit of its exclusively educational character. Since trade shows by their very nature tend to improve the condition and efficiency of the persons engaged in a particular industry and to improve the products, calling them "educational" would hardly serve the pur-

pose except in an atmosphere of the utmost lenience on the part of the IRS.

The current attitude of the Service, which is far from lenient, is causing concern to many who feel that it will lead to curtailment of the activities of associations, to the resulting detriment of business generally. Advocates of the association feel that the services which they render in their fields justify a continuation of the generosity with which the IRS has treated them in the past.

Alternatively, there are signs even among trade-show people themselves of a growing tendency either to pay tax on the unrelated business income or weigh the advisability of relinquishing exempt status altogether. In situations where offsetting total deductible expenses against combined income from all sources would result in a lower tax than would be owed on unrelated business income only, the second alternative would obviously be preferable.

This would be a matter for the individual organization to decide after an analysis of its own potential tax liability under both arrangements and with the advice of a competent tax practitioner. ☆

New decisions

No deduction for gift made indirectly to city. Taxpayer, a sculptor, created a statue which he donated to a foreign government that in turn formally presented it to an American city. The cost of the statue fails to qualify as a deductible contribution to the city. *Rev. Rul.* 58-405.

Numismatic society not educational. The additional 10% deduction for charitable contributions does not apply to contributions to an organization formed for the purpose of collecting and preserving coins and medals and related activities, including maintenance of facilities for research in such fields; its primary activities are not educational. *Rev. Rul.* 58-433.

No exemption for foundation which might benefit private individuals. Taxpayer foundation was created by a combined will and deed of trust which a state court interpreted as providing for payments to relatives and to charities after the donor's death. The court holds that these family gifts cannot be regarded as mere charges reducing the charitable gift. They may well be paid out of income and for this reason the foundation fails to qualify for an exemption; the income may inure to the benefit of a private person. *McGillick Co.*, 30 TC No. 120.

Privately owned school's tax-exempt status revoked retroactively. A privately owned school secured tax exemption in 1946 based on submission of incorrect statements. In 1951 the Commissioner audited the school's records and revoked the tax-exempt status retroactively. The court finds the school was in fact organized not only to operate a business school but to provide pecuniary benefits to its stockholders, and accordingly upholds the retroactive revocation of tax-exempt status. The Commissioner's further determination that all payments made to or on behalf of the individual stockholders constitute dividends to them is reversed to the extent that the payments are found to represent actual selling expenses, reasonable salaries, and loans. *Carter*, TCM 1958-166.

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TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

Partners' main asset was lease: IRS disallows amortization

IF THE ASSETS of a partnership consist of a lease and equipment, did an incoming partner buy a partnership interest or an interest in the assets? If he owns an interest in the assets, he may, of course, amortize his cost over their life. This is the question at issue in a New Tax Court case (*Sumers*, Docket No. 73169), in which the IRS is taking the position that a partnership interest was bought as against the contention of the taxpayer that he is entitled to amortize his payments.

The facts initially involve a partnership which did not include the taxpayer. Dr. Fuhrman, with whom taxpayer became associated as a partner, had previously been associated with another physician-radiologist. Dr. Fuhrman and the other doctor had rendered all necessary radiological services in a particular hospital and their lease arrangement provided for the hospital to furnish space and services; the partners had the exclusive right to render all the hospital's radiological services, as well as the right to treat their own patients.

When the first partnership was dissolved, Dr. Fuhrman, with the consent of the hospital, obtained all the assets of the partnership. The agreement into which he then entered with taxpayer (Dr. Sumers) provided that the capital of the partnership would consist of the lease and equipment, and that it would assume the $18,000 liability incurred by Dr. Fuhrman in buying out his former partner. Dr. Sumers was to receive a one-third undivided interest in the assets as defined in the agreement, subject to the $18,000 liability, for $30,000 payable over a term of years. It is the installments paid on the $30,000 which are at issue, since Dr. Sumers wishes to amortize them, to the extent they are attributable to his interest in the lease, over the term of the lease.

Two previous cases in this area agree on the status of the partner who buys out his retiring associate, but throw no light on the status of a new partner. In *Risko* (26 TC 485), an employment agent who bought out his partner was held to have made a capital expenditure, but was allowed to amortize it over the remaining 20 months of the five-year term of the partnership agreement. The identical conclusion was reached in the case of an architectural partnership in *Silling* (27 TC 701) in which the remaining partner, now a sole proprietor, was allowed to amortize the payments over the lives of certain contracts which were not completed at the time of dissolution. In both these cases, however, the business continued as a sole proprietorship.

Had the situation arisen under the 1954 Code, even though the Commissioner might be held correct in his apparent position that Dr. Sumer bought a partnership interest, taxpayer could have accomplished his purpose by exercising the election under Sections 743 and 754. Section 754 provides that a partnership may file an election to have a transfer of partnership interest treated as provided in Section 743, which permits the transferee partner, only, to increase or decrease the basis of partnership assets by the difference between the transferee partner's basis for his interest in the partnership and his proportionate share of the basis of partnership property. In the *Sumer* case, the partnership has no assets other than the lease and equipment which constitute its property. No similar provision, however, exists in the 1939 Code. ☆

Partners seek capital gain on fee for canceling job

THE MEMBERS of a partnership are now seeking in the Tax Court to obtain capital gains on the monies paid them in consideration of canceling a contract to produce motion pictures. (*Holt*, Docket No. 72675) The partnership, consisting of Holt and two others, contracted with Paramount to produce a specified number of pictures for $20,000 per picture plus an amount equal to 25% of the "gross profits" realized from the pictures. Subsequently, after several pictures had been produced, Paramount released Holt and the partnership from their obligation to produce the remaining motion pictures and paid $153,000 to the partnership. Correspondingly, Holt and the partnership agreed to release Paramount from its obligation to finance and distribute the unproduced films, as well as from its obligation to pay the 25% of "gross profits" on the unproduced films.

The taxpayer, Holt, bases his claim on two arguments, which are mutually exclusive. Either the partnership sold a capital asset, or the partners sold their partnership interests.

According to Section 1221(4), accounts or notes receivable acquired in the ordinary course of trade or business for "services rendered" in the past are not capital assets, but a receivable arising from a promise to render future services would be a capital asset. Taxpayer maintains this section would apply because the contractual rights sold were not "acquired in the ordinary course of trade or business," nor did they arise from "services rendered."

On the other hand, Section 751 (the collapsible partnership provision) defines an unrealized receivable so as to include any right to payment for "services rendered, or to be rendered." This language is broad enough to deny capital-gain treatment, and differs from Section 1221(4). There is no reason, however, to believe that Congress, by its enactment of Section 1221(4), intended to modify the landmark cases of *Thurlow E. McFall*, 34 BTA 108 (1936) and *George K. Gann*, 41 BTA 388 (1940). These cases established the proposition that the sale or cancellation of a personal service contract will give rise to ordinary income.

Other cases in this area clearly illustrate how difficult it has been for taxpayers to obtain capital gains from the cancellation of personal service contracts. See *Starr Brothers, Inc.*, 204 F.2d 673 (2d Cir., 1958); *General Artists Corp.*, 205 F.2d 360 (2d Cir., 1953); *C. F. Jones v. Corbyn*, 186 F.2d 450 (10th Cir., 1950). Also the recent decision in *Pittston Co.*, Docket No. 24531 (2d Cir., 2/11/58 *rev'g* 26 TC 967 (1957), would seem to indicate the extreme difficulty for taxpayers to obtain capital-gain treatment on payments received in cancellation of contracts.

In his argument with respect to Section 1221(4), the taxpayer has character-

ized the transaction as a sale by the partnership of its underlying asset. Section 751 is relevant to the alternative argument if it is determined that the property Holt sold was his interest in the partnership. The case points up the interesting factual issue which is present if all the partners sell their interest at the same time to one purchaser, namely, whether the partners sold partnership interests or the partnership sold its assets. In essence, a new type of *Court Holding Company* issue may be involved. ☆

New partnership decisions this month

Jury doesn't have to believe paper-perfect family partnership. While there was no dispute that, on paper, the taxpayers created a perfect partnership with the trusts they created for their children, it was a jury question whether there was a good-faith partnership. The jury having decided against taxpayer, the court will not set its verdict aside. *Eisenberg,* DC Penna., 7/22/58.

Effective date of sale of partnership interest determined. In December 1950 taxpayer agreed to sell his partnership interest to the remaining partners effective midnight January 1. The actual sales agreement was made January 2. He, therefore, included his share of profits since the previous October 1 in his 1951 return. The court agrees with taxpayer that the sale was made for tax purposes in January and no part of the final three months' profit was taxable in 1950, even though a tax saving motivated the parties in setting up the transaction by agreement among themselves in this way. [The 1954 Code provides specific rules for treatment of partner's income on transfer of his interest.—*Ed.*] *Grant,* DC Neb., 6/27/58.

New fraud and negligence decisions

Public accountant's failure to file returns not fraudulent. A public accountant specializing in income taxes did not file income tax returns or pay taxes. He explained this as due to overwork and confusion of mind. The court finds that there is no clear and convincing evidence of a fraudulent intent to evade taxes. Cited in taxpayer's favor were the facts that taxpayer did keep complete and accurate records of his gross income, which he furnished to the investigating agent, and that for each of the years in question he did submit a written request for extension to file his return. *Wells, Jr.,* TCM 1958-160.

IRS memo re taxpayer's accountant's statements not available under new anti-Jencks law. Taxpayer had been convicted of income tax evasion. On appeal he asserts that he was improperly denied the opportunity to inspect a memorandum prepared by a Revenue Agent after conferring with taxpayer's accountant, who had prepared an affidavit at that conference and had appeared as a Government witness at the trial. This court holds that the lower court properly denied inspection of the memo. The new law enacted after the Supreme Court, in the *Jencks* case, had required disclosures of statement by Government witnesses is not applicable here. That statute applies only to writings by the witness—the memorandum at issue here was merely the recollection of the Agent, not a statement of the witness. *Palermo,* CA-2, 8/18/58.

Jury finds fraud in omission of gifts in contemplation of death. The Commissioner assessed some $7,000 additional estate tax asserting that certain transfers of bonds to the decedent's son were in contemplation of death. The jury finds that two transfers were. The charge to the jury mentions the transfers as having been disclosed in the return, although not included in the computation of taxable estate. Nevertheless, the Commissioner asserted the 50% civil fraud penalty and the jury upholds it. *Stiles,* DC Fla., 7/21/58.

Tougher fraud sentences now being imposed

VERY SEVERE penalties have been imposed by Federal courts in recent tax evasion cases. The Intelligence Division of the IRS reported one nine-year prison sentence for a convicted violator, and one seven-year sentence. Numerous sentences of two to five years were reported in illicit distilling cases. ☆

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New compensation decisions this month

Corporation's payments to widow of former president held gift. In 1952, taxpayer, the widow of the president of a corporation, was paid an amount equal to his salary for five months. The court states seven guides to determining whether such payments are gifts or compensation: (1) A payment made directly to the widow instead of the estate would tend to indicate a gift, rather than compensation. (2) If there was a legal obligation to make the payment, it is not a gift. (3) The widow's conferring a benefit on the company would indicate that the payment was not a gift. (4) If the company intended a gift, it is a gift. (5) If the payments are related to profits, it may be a dividend. (6) If the widow is an officer, director or majority stockholder, there is less likelihood of a gift. (7) If the deceased officer was not properly compensated for his services during his life, the payments are probably compensation. All of these tests in this case point to the payments' being a gift rather than compensation or other income and the court holds they are not taxable. [The IRS has announced that it will no longer seek to tax under the 1939 Code voluntary payments to widows unless there is clear evidence that they were intended as compensation.—*Ed.*] *Heyburn Estate, Citizens Fidelity Bank & Trust Co., Ex.*, DC Ky., 2/26/57.

SUP trust tax-exempt. A trust established by a corporation pursuant to a supplemental unemployment benefit plan established through negotiation with the employees to supplement state system unemployment compensation benefits in a prescribed manner during a particular period to eligible employees as a result of a reduction in force or temporary layoff, qualifies for tax exemption under Section 501(c)(9) as a voluntary employees' beneficiary association. *Rev. Rul.* 58-442.

Contributions by predecessor to pension plan not affected by reorganization. Pursuant to a transfer of assets and liabilities for stock under a Section 368(a)(1)(C) reorganization, a corporation's qualified employees' pension plan was combined with the qualified plan of the successor corporation. The IRS rules that the deductibility of contributions made by the predecessor corporation to its plan prior to the reorganization is unaffected. Also, the transfer of funds from the insurer of the predecessor's plan to the successor's plan will not result in taxable income to such successor corporation. *Rev. Rul.* 58-406.

Trust as lump-sum beneficiary of employees' plan qualifies for capital gain. Long term capital-gain treatment is applicable in a case where a lump-sum distribution of an employee's interest under a qualified employees' profit-sharing plan is paid to a trust designated as the employee's beneficiary. The Code contains no restriction on beneficiaries that may qualify for capital-gains treatment. *Rev. Rul.* 58-423.

Accrued Army officer's pay for 1932-1934 is "back pay." Remuneration received by commissioned officers or former commissioned officers under the Act of September 2, 1957, for pay earned during the period July 1, 1932, to June 30, 1934, qualifies for "back pay" treatment under Code Section 1303. It is wages subject to withholding of income tax at source. *Rev. Rul.* 58-443.

Court denies "retroactivity" of IRS policy change on widow's tax. A payment of $12,000 to the widow of a deceased employee of a bakery corporation is held to be a gift, not compensation. Very few facts are given. In 1950 the IRS issued IT 4027 taking the position that salary continuation payments to a widow would be taxed as income. Taxpayer here was in 1950 voted $12,000 paid in that year. The Commissioner apportioned the payment over the year 1950, taxing as income the portion applicable to time after IT 4027. The court finds that none is income; all is a gift. One of the reasons the court gives for its decision is that no retroactive effect should be given to IT 4027. Here the payments were authorized and begun prior to its issuance. [The IRS has announced that it will no longer seek to tax under the 1939 Code voluntary payments to widows unless there is clear evidence that they were intended as compensation.—*Ed.*] *Campbell*, DC Tenn., 4/10/58.

Contributions to profit-sharing plan deductible although administration was defective. Taxpayer's trust and profit-sharing plan was approved by the Commissioner in 1945. The Commissioner, however, disallowed contributions for 1949 and 1950 on the ground that the trust and plan was not *operated* exclusively for the benefit of the employees. The Tax Court upheld the disallowance. The principal variations in operation from the original plan were (1) the trustees failed to keep books during the first two years of the plan and therefore they did not become aware of some benefits due employees until later; (2) no distributions were made to employees until 60 days prior to the Tax Court hearing in this case; (3) payments to the trust were made in the form of non-interest-bearing notes which were subsequently redeemed for cumulative preferred stock dated back to the date of the notes. This court allows the deduction. The lack of books during the first two years did not result in any gain to the employer or prejudice to the employees. The failure to make the distributions was due to the fact that the Commissioner was investigating the taxpayer and it did not know what to do. Since this default was in effect caused by the Commissioner, taxpayer should not suffer for it. The variations from the plan did not result in either a substantial loss to the beneficiaries nor did it benefit the employer. The court specifically notes that this is not a case of taxpayer's failure to heed a warning. *Time Oil Co.*, CA-9, 7/30/58.

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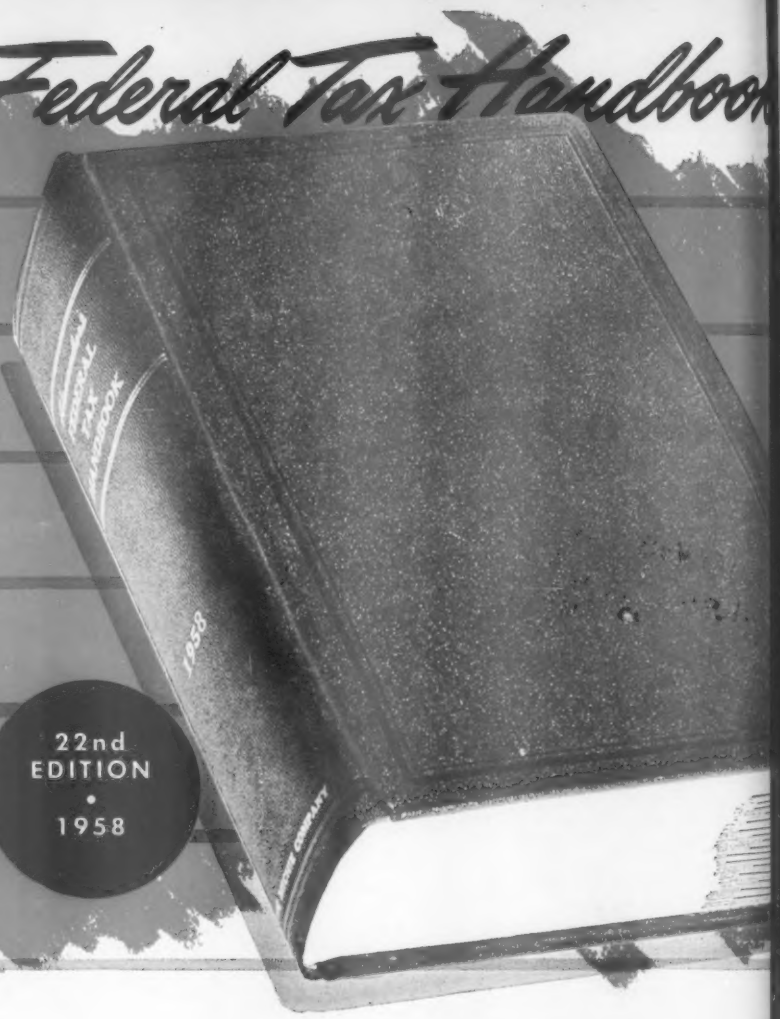

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